



## The Baseline Scenario 2010-01

**Updated:** 5-4  
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## Doom Loop, UK Edition

**Simon Johnson** | 03 Jan 2010

In the Sunday Times (of London) today, Peter Boone and I address what the British authorities can do to break their version of the boom-bust-bailout cycle.

There is a certain amount of fatalism about these issues in Europe. This is misplaced. In the short-term, European policymakers have an important opportunity to diminish the political power of big banks, particularly because peer review – through the European Commission, the G20, and even the IMF – is more likely to have impact there than in the United States.

It's an open question whether the degree of ideological capture by finance was stronger over the past decade in the US or the UK. But at least leading UK policymakers have started to push back against their banks; in the US, Paul Volcker remains a relatively lonely quasi-official voice.

*By Simon Johnson*

## No to Bernanke

James Kwak | 03 Jan 2010

The American Economics Association is meeting in Atlanta, where Simon says it is frigid. I went to an early-January conference in Atlanta once. There was a quarter-inch of snow, the roads turned to ice, and everything closed. All flights were canceled, so I and some friends ended up taking the train to Washington, DC, which had gotten two feet of snow, and eventually to New York.

Paul Krugman's speaking notes are [here](#). Ben Bernanke's are [here](#).

Bernanke's speech is largely a defense of the Federal Reserve's monetary policy in the past decade, and therefore of the old Greenspan Doctrine dating back to the 1996 "irrational exuberance" speech—the idea that monetary policy is not the right tool for fighting bubbles. The Fed has gotten a lot of criticism saying that cheap money earlier this decade created the housing bubble, and I think it certainly played a role.

But I actually agree with Bernanke here:

"[T]he most important source of lower initial monthly payments, which allowed more people to enter the housing market and bid for properties, was not the general level of short-term interest rates, but the increasing use of more exotic types of mortgages and the associated decline of underwriting standards. That conclusion suggests that the best response to the housing bubble would have been regulatory, not monetary. Stronger regulation and supervision aimed at problems with underwriting practices and lenders' risk management would have been a more effective and surgical approach to constraining the housing bubble than a general increase in interest rates."

(Note that the purpose of stronger regulation, according to Bernanke, is to constrain the housing bubble that he denied existed at the time—not to protect consumers.)

The problem, for the Greenspan-Bernanke legacy at least, is that the Fed is also the chief regulator of the financial system, with jurisdiction over all bank holding companies and primary responsibility for consumer protection statutes applying to all financial institutions. Here Bernanke makes a partial attempt at an apology:

“The Federal Reserve and other agencies did make efforts to address poor mortgage underwriting practices. In 2005, we worked with other banking regulators to develop guidance for banks on nontraditional mortgages, notably interest-only and option-ARM products. In March 2007, we issued interagency guidance on subprime lending, which was finalized in June. After a series of hearings that began in June 2006, we used authority granted us under the Truth in Lending Act to issue rules that apply to all high-cost mortgage lenders, not just banks. However, these efforts came too late or were insufficient to stop the decline in underwriting standards and effectively constrain the housing bubble.”

In other words, we did nothing until 2005, and then we didn’t do much. [Also see **Update 2** below.]

I don’t really care about apologies. The more important question is what Bernanke and the Fed will do in the future. On that front, he has this to say:

“The Federal Reserve is working not only to improve our ability to identify and correct problems in financial institutions, but also to move from an institution-by-institution supervisory approach to one that is attentive to the stability of the financial system as a whole. Toward that end, we are supplementing reviews of individual firms with comparative evaluations across firms and with analyses of the interactions among firms and markets. We have further strengthened our commitment to consumer protection. And we have strongly advocated financial regulatory reforms, such as the creation of a systemic risk council, that will reorient the country’s overall regulatory structure toward a more systemic approach. The crisis has shown us that indicators such as leverage and liquidity must be evaluated from a systemwide perspective as well as at the level of individual firms.”

There are basically only two things in this paragraph, one of which is disingenuous at best. Bernanke claims that he is getting serious about consumer protection, yet he has lobbied against the Consumer Financial Protection Agency, which everyone who is serious about consumer protection wants. I’m disappointed that Bernanke would stoop to this kind of misleading rhetoric.

The other thing is a lot of talk about systemic risk. Yes, systemic risk is important. But all the words I hear about it, and the fact that the importance of systemic risk is one of the few things that everyone can agree on, are making me start to worry. Specifically, I wonder if a lot of regulatory apparatus aimed at systemic risk will serve as a distraction from old-fashioned regulation of individual institutions. Yes, it's true that the thing that hit us in 2008 was systemic risk. But it's also true that regulators already had the power to supervise Citigroup, Bank of America, Wachovia, Washington Mutual, Lehman Brothers, Bear Stearns, and Countrywide and force them to pare back their risky activities—and didn't. Talking about systemic risk is a way of passing the buck—or excusing regulatory failure by saying that regulators didn't have the authority to look at systemic risk. But the fact remains that someone looked at Citigroup's range of businesses and its asset portfolio and decided it was a healthy bank. That was at least as big a problem.

I've been on the fence about Bernanke's confirmation, mainly because I'm not so optimistic we'll get anyone better from a policy standpoint, and we could certainly get someone worse from the standpoint of intelligence, knowledge, thoughtfulness, and work ethic. But now that I've read this speech, I'm against confirmation.

**Update:** I should clarify one thing. I am sure there are better people out there. I'm less confident about whomever Obama and his advisers would pick. This is a deeply centrist administration, at least on economic issues, and one that is absolutely not going to make a major policy shift anytime soon; whether or not we agree with them, their current message is that they have done a good job fixing the financial system and running the economy. So I think that if Bernanke by some miracle were not confirmed, Obama would take pains to appoint someone with the same policy positions.

**Update 2:** Mike Konczal at [Rortybomb](#) points out what Bernanke left out of Bernanke's defense of the Fed: the fact that the Fed actively ignored warnings going back to 1998. Funny how a factually correct statement can be deeply misleading.

*By James Kwak*

## Another Approach to Compensation

James Kwak | 04 Jan 2010

The problems with the traditional model of banker compensation are well known. To simplify, if a trader (or CEO) is paid a year-end cash bonus based on his performance that year (such as a percentage of profits generated), he will have an incentive to take excess risks because the payout structure is asymmetric; the bonus can't be negative. That way the trader/CEO gets the upside and the downside is shifted onto shareholders, creditors, or the government.

I was talking to Simon this weekend and he said, "Why a year? Why is compensation based just on what you did the last year? That seems arbitrary." When I asked him what he would use instead, he said, "A decade," so I thought he was just being silly. But on reflection I think there's something there.

Most approaches to solving the compensation problem focus on changing the way the bonus is paid out, not the way it is calculated in the first place. Many people think that bonuses should be paid out in restricted stock that (a) vests over five years and (b) cannot be sold for some period of time after it vests. (This is already the case for top executives—but not most employees—at many big banks.) The goal here is to tie the eventual payout to the long-term performance of the company, via its stock price.

This is better than all cash, but it still has a few problems. For one, the top executives at Bear Stearns and Lehman Brothers already had this type of bonus payout, and it didn't help. For another, tying managers' incentives to shareholders isn't necessarily what you want when it comes to highly leveraged banks, since shareholders also have the incentive to take on too much risk (since they can shift losses to creditors or the government). (For this reason, Lucian Bebchuk has suggested tying long-term compensation to a basket of securities that includes not just common stock but also preferred stock and some kinds of debt.) In addition, this type of payout structure wouldn't change the incentives for individual traders, since their bonus is calculated based on the one-year performance of their individual book, and then paid out depending on how the entire company does; even if those trades blow up the next year, chances are they won't affect the stock price that much.

Clawbacks in future bad years are another idea, but at least as proposed by the Obama administration, I think they would only apply in

cases of material misrepresentation. Also, it's hard to claw money back from people who have left your company. In the business world generally, sales compensation agreements often have clawback provisions, but it's generally understood that you're not going to sue your former employees to collect on them. (Besides, often the money has already been spent.)

Simon's idea (at least as I've thought it out) is to change the way the bonus is calculated in the first place, instead of (or in addition to) the way it is paid out. He's right: why should your bonus be calculated every 365 days and based on the last 365 days' results, weighted equally? For one thing, this kind of lumpiness encourages behavior that is bad for the company; think about all those discounts that salespeople give at the end of a quarter or a year trying to make their quota. More important, Simon's main point is that December 31 is just too soon to determine how well an individual did during that year.

Instead, what about making your 2009 year-end bonus based on your performance in 2006, 2007, and 2008? That is, by the end of 2009 you would have better information about whether the trades placed in those years had turned out well or badly. There are all sorts of variations possible: you could weight the years differently; you could include 2009 (with a low weight because it's too early to tell); you could do it on a quarterly basis to smooth out the lumps; you could pay out on a quarterly basis; and so on. But the basic principle is that you don't calculate the bonus until enough time has elapsed to ensure that the employee deserves it. If you wait long enough, you could even just pay it out in cash instead of restricted stock.

The first objection will be that new employees get screwed, since they will get lower bonuses until they have been with the company for a few years. There are a couple possible solutions to that. The one I like less is that for someone who joins on 1/1/2009, his 2009 bonus could have a full-size target and be based on 2009 performance; but his 2010 bonus would be based on two years of results, his 2011 bonus on three years of results, and his 2012 and later bonuses on four years of results.

My preferred solution, though, is that people simply get smaller bonuses (and maybe somewhat higher salaries to compensate) when they switch companies, and only get the big bonuses after they've been around a few years. (You can imagine a new equilibrium where bonuses for employees in their first years are lower than today, but bonuses for long-term employees are higher. I'm not saying in this post that total

compensation has to go down; that's a separate issue.) In the technology startup industry, employees get stock options that vest over four years (with a one-year cliff). If you leave after two years, you give up your last two years of options (and unless the company is already public, you have a difficult choice about whether or not to exercise your options). This increases the cost to the employee of switching companies, which is good on two levels. First, as far as the division of the pie is concerned, it benefits employers (shareholders) relative to employees, which would be a good thing for the banking industry (as opposed to, say, the fast food industry). Second, it makes the pie bigger, since companies are more productive if they have more stable workforces. For these reasons, banks should actually *want* to move to this type of bonus calculation.

Now, how do we get there from here? Like many markets, if one firm changed its policy and the others didn't, it would be at a competitive disadvantage. (Of course, this problem exists with all proposals to change compensation practices, including the restricted stock ideas.) First, the banks could possibly get there on their own, just like airlines do when they raise prices; one announces a change, and then (sometimes) the others copy it. This could be helped along if one of those famous self-regulatory bodies would recommend this as a new compensation structure. Or if Goldman took the lead; since (I think) it has longer average tenure than most banks, if it changed its policy today, fewer employees would be affected than at other banks; and if you're just two years into your banking career at Goldman, would you really leave for Citigroup now rather than sticking it out at Goldman until you have the tenure to take advantage of the new policy? Second, we could have legislation. Or third, we could have regulatory action, since the Fed has already said that compensation practices fall under its jurisdiction as a guarantor of the health of individual bank holding companies and the financial system as a whole.

Changing the basis of the bonus calculation is a more direct way of dealing with the current incentive problems than changing the form of the payout. How about it?

*By James Kwak*

## The Crisis This Time

Simon Johnson | 04 Jan 2010

This morning at the American Economic Association (AEA) meeting in Atlanta, I was on a panel, “Global Financial Crises: Past, Present, and Future,” with Allen Sinai (the organizer), Mike Intriligator, and Joe Stiglitz.

The Wall Street Journal’s RealTime ran a summary of my main points: growth in 2010 may be faster or slower – depending on how lucky we get- but, either way, the most serious problem we face is that 6 banks in the U.S. are now undeniably (in their own minds) Too Big To Fail.

Reckless and mismanaged risk-taking is the sure outcome. But don’t take my word for it – read Larry Summers’s 2000 Ely Lecture to the AEA. The best line is on p.13, “[I]t is certain that a healthy financial system cannot be built on the expectation of bailouts” (American Economic Review, vol. 90, no. 2; access through your library).

A number of participants asked for a copy of my slides – please use this version (in addition there was some other material that will appear shortly in 13 Bankers, so we’re not putting it on the web yet).

*By Simon Johnson*

## Yet More Financial Innovation

James Kwak | 05 Jan 2010

Andrew Martin has an article in [The New York Times](#) on the dynamics of the debit card industry. I don't have any expert knowledge to add, but here's the summary: Visa has been increasing its market share by *increasing* the prices it charges to merchants; it takes those higher transaction fees and passes some of them on to banks that issue Visa debit cards, giving them an incentive to promote Visa debit cards over other forms of debit cards. Not only that, there are different fees on debit cards depending on whether you use them like a credit card (signing for them) or like an ATM card (entering a PIN). Signing costs the merchant more, so the banks and Visa give you incentives to sign instead of using a PIN. The end result is higher costs for merchants, who pass them on to you.

Ordinarily this should create the opportunity for a new entrant (say, NewCard) to offer lower fees. But there are three problems that I can see. First, individual customers would have no incentive to use NewCard rather than Visa, since any savings get distributed across all customers of a given merchant (through lower prices). Second, there are massive technological and marketing barriers to entry. Third, even if merchants and customers want NewCard, the banks—the distributors of debit cards—don't.

Tell me again, how does this benefit society? Theoretically having a couple of big transaction processing networks could lower costs relative to having a lot of smaller networks because of economies of scale. But we're probably talking a couple of pennies per transaction there, while the fees that Visa charges are an order of magnitude bigger.

**Update:** It struck me that I have in the past cited the debit card as an example of a beneficial financial innovation. I may have to rethink that. Sure it provides benefits, like not having to carry around lots of cash. But I'm not sure those benefits are worth the amount that the networks and the banks are sucking out of the system (resulting in higher prices for everyone).

*By James Kwak*

## Bye-Bye, Bank of America

James Kwak | 05 Jan 2010

As I was waiting for the very nice bank teller to give me my bank check for the balance in my account, the woman next to me was trying to tell her very nice teller that she did not want overdraft protection on her account. She was told she would have to wait fifteen minutes to talk to a “personal banker” to remove it. Weren’t big banks supposed to be more efficient?

My nice “personal banker” made the mistake of asking me why I was closing my account. So I told him:

- One of my local banks refunds my ATM fees at other banks.
- My other local bank pays 0.75% interest—on an ordinary checking account.
- Bank of America breaks the law.
- Bank of America closed two out of the three branches in my town.
- Oh, and it’s too big, and presents a systemic risk to the U.S. economy.

Behind him was a sign encouraging people to use their debit cards to pay for purchases to take advantage of a “savings” program that moves what is already your own money from your checking account to your savings account.

Afterward I went out for a martini even though it was just before noon. Yes, changing your bank account is a hassle. But the satisfaction is worth it.

*By James Kwak*

## **“All Serious Economists Agree”**

**Simon Johnson | 05 Jan 2010**

The most remarkable statement I heard at the American Economics Association meeting over the past few days came from an astute observer – not an economist, but someone whose job involves talking daily to leading economists, politicians, and financial industry professionals.

He claims “all serious economists agree” that Too Big To Fail banks are a huge problem that must be addressed with some urgency.

He also emphasized that politicians are completely unwilling to take on this issue. On this point, I agree – but is there really such unanimity among economists?

I ran his statement by a number of top academics over the past day and – so far – it holds up. But this may just reflect the kinds of people I meet.

Still, it is an interesting claim that stands until refuted – send or post details of serious people (in economics or elsewhere) who currently think Too Big To Fail Is Just Fine (other than people in government or big banks, of course).

*By Simon Johnson*

## Did Demand for Credit Really Fall?

James Kwak | 06 Jan 2010

One standard attack against banks is that they have not expanded lending sufficiently to help the economy recover. The standard defense has been that the supply of credit collapsed only in response to a collapse in the demand for credit. The primary measure of demand for credit that I know of is the one compiled by the Federal Reserve by surveying bank lending officers; it shows falling demand for all types of credit from 2006, with an acceleration in the fall in late 2008.

Presumably this is based on the number of people walking into bank branch offices (or calling up on the phone, or applying online, etc.). But Google has another way of tracking demand for credit; the Google Credit & Lending Index measures the relative volume of searches\* for certain terms like “credit card,” “loan,” and “credit report.” There’s some seasonality there, but in general the levels look higher in Q4 2008 and Q1 2009 than in Q4 2007 and Q1 2008.

There are a couple of plausible reasons for this discrepancy. One is that this is a silly index and should be ignored. The other is that people wanted credit just as much (or more) than before the crisis, as measured by Internet searches, but they couldn’t find it online (because fewer providers were advertising, or the terms offered weren’t as generous, etc.), so they didn’t bother going into the branch (or calling).

I’m not going to be able to resolve this here, but it comes down to which you think is a better source of information: bank officers judging based on their impressions of incoming activity, or people sitting at their keyboards searching for “credit cards.”

\* Relative to all Google searches, so numbers might be affected by seasonal or other patterns elsewhere in the world; for example, as shopping-related searches go up in December, everything else might see a (small) corresponding decline.

*By James Kwak*

## Still No To Bernanke

Simon Johnson | 07 Jan 2010

We first expressed our opposition to the reconfirmation of Ben Bernanke as chairman of the Fed on December 24th and again here on Sunday. Since then a wide range of smart economists have argued – at the American Economic Association meetings in Atlanta - that Bernanke should be allowed to stay on.

I've heard at least six distinct points. None of them are convincing.

1. Bernanke is a great academic. True, but not relevant to the question at hand.
2. Bernanke ran an inspired rescue operation for the US financial system from September 2008. Also true, but this is not now the issue we face. We're looking for someone who can clean up and reform the system – not someone to bail it out further.
3. Bernanke was not really responsible for the failures of the Fed under Alan Greenspan. This is a stretch, as he was at the Fed 2002-05, then chair of the Council of Economic Advisers, June 2005-January 2006. Bernanke took over as Fed chair in February 2006, when tightening (or even enforcing) regulation could still have made a difference. He had plenty of time to leave a mark and, in a very real sense, he did.
4. Bernanke understands the folly of the Fed's old bubble-building ways and is determined to reform them. This is wishful thinking. There was nothing in his remarks this weekend (or at any time recently) to support such an assessment.
5. Bernanke will be tough on banks when needed. Again, there is not a shred of evidence that would support such a view – the markets like him because they see him as a soft touch and that's great, except that it encourages further reckless risktaking by banks considered Too Big To Fail and leads to another financial meltdown.
6. Dropping Bernanke would disrupt the process of economic recovery. This is perhaps the strangest assertion – we're in a global rebound phase, fueled by near zero US short-term interest rates. Official forecasts will soon go through a set of upward revisions and calls for further worldwide stimulus will start to sound distinctly odd. Now is the perfect time to change the chair of the Fed.

*By Simon Johnson*

## Hoenig Talks Sense On Casino Banks

Simon Johnson | 07 Jan 2010

Thomas Hoenig, President of the Kansas City Fed, has been talking sense for a long time about the dangers posed by "too big to fail" banks. On Tuesday, he went a step further: "Beginning to break them, to dismember them, is a fair thing to consider."

Hoenig joins the ranks of highly respected policymakers pushing for priority action on TBTF, including some combination of size reduction and/or Glass-Steagall type separation of casino banks and boring banks.

As Paul Volcker continues to hammer home his points, more policymakers will come on board. Mervyn King – one of the most respected central bankers in the world - moves global technocratic opinion. Smart people on Capitol Hill begin to understand that this is an issue that can win or lose elections.

Ben Bernanke still refuses to address "too big to fail" directly and coherently. He needs to make a major speech focussing on bank size, confronting the critics of today's big banks in detail (if he can) and specifying concretely how banks will be prevented from becoming even larger. Without such a clear statement, he will have lost all credibility even before his second term begins.

The independence of central banks is earned, not written in stone for all time. Mr. Bernanke seriously undermines the Federal Reserve System by remaining essentially silent on this crucial issue.

*By Simon Johnson*

# The Problem with Positive Thinking

James Kwak | 07 Jan 2010

There's a quotation by Stan O'Neal that I've looked for occasionally and failed to find. John Cassidy found it for me (*How Markets Fail*, p. 274; original source is *The New York Times*). It was an internal memo from O'Neal describing the company's second-quarter 2007 results (which were good, at least on paper). Here are some quotations from memo in the *Times* article:

"More than anything else, the quarter reflected the benefits of a simple but critical fact: we go about managing risk and market activity every day at this company. It's what our clients pay us to do, and as you all know, we're pretty good at it."

"Over the last six months, we have worked successfully to position ourselves for a more difficult market for C.D.O.'s and been proactively executing market strategies to significantly reduce our risk exposure."

Greg Zuckerman, in *The Greatest Trade Ever*, has this from O'Neal in 2005 (p. 173): "We've got the right people in place as well as good risk management and controls." (No original source—the entire book has only forty-three end notes, at least in the pre-publication copy that Simon got.)

Since then, we've all had our fun at O'Neal's expense (and he's had his \$161 million golden parachute, although presumably it ended up being worth considerably less) and moved on. Most likely he simply had no idea what was going on; the other possible explanations are worse.

But that first quotation has always bothered me, because it reflects a problem that goes far beyond Wall Street, and something I always found particularly distasteful about Corporate America: CEOs, and business people in general, saying things they want to be true, without bothering to find out if it actually is true.

Do all people behave this way? ("Heck of a job you're doing, Brownie.") Maybe, but not all people are CEOs that have investors and employees listening to their every word. Everyone who writes for a top newspaper or for a subset of the top magazines (*The New Yorker*, *The Atlantic*, etc.) has every word he or she writes fact-checked. The fact-checkers literally go word by word and cross them out when they are

confident they are accurate. There's no way a good fact-checker would have allowed O'Neal to say "successfully" without proving it. If he had had to prove it, he would have known it was a lie. As it was, he was able to get away with it, probably without even having to think about whether he was living in a fantasy or not. (And, of course, O'Neal almost certainly didn't write the memo to begin with.)

The result is that smart people know to ignore everything a company executive says in public that is not backed up by facts in the public domain, and everyone else gets bamboozled. And if you don't put up the confident, cheerful face on CNBC, you'll get slammed because all the other people on CNBC do. So we end up with this charade of everyone spouting the talking points fed to them by their PR people (I was in marketing at Internet boom company; I've written those talking points) without even knowing if they are true, which means they can never be held responsible (since any misrepresentation they make isn't "willful").

Is there a solution? I wish business executives would show a little more interest in reality, but that isn't going to happen by itself. Maybe there should be a different legal standard for certain types of speech by corporate officers, so they can be held responsible on some level for making inaccurate statements, even if they don't know they are inaccurate. That would inspire greater respect for the truth. But mainly this is just a pet peeve of mine that isn't going to change.

*By James Kwak*

## Good Idea Coming

Simon Johnson | 07 Jan 2010

One striking aspect of the public debate about the future of derivatives – and how best to regulate them – is that almost all the available experts work for one of the major broker-dealers.

There are a couple of prominent and credible voices among people who used to work in the industry, including Frank Partnoy and Satyajit Das. And there are a number of top academics, but if they help run trading operations they are often unwilling to go on-the-record and if they don't trade, they lack legitimacy on Capitol Hill and in the media.

The Obama administration is criticized from various angles – including by me and, even more pointedly, by Matt Taibbi – for employing so many people from the finance sector in prominent policy positions. But, the administration pushes back: Where else can we find people with sufficient expertise?

The defense sector faced a similar problem after World War II. The rising importance of technology in combat meant that the military needed specialized suppliers who would invest large amounts of private capital in developing tanks, airplanes, radar, and other types of equipment. But there was – and still is – a real danger that these companies would capture the Defense Department and push it to buy overly expensive and ineffective technologies (or worse).

President Eisenhower famously warned in 1960, as he was leaving office, about the military-industrial complex. His concise remarks were brilliant – look at the text or YouTube versions. And C. Wright Mills' influential *The Power Elite*, published in 1956, put weapons suppliers at the center of our national power structure. (link: ; but this may be copyright violation.)

Constraining the power of defense contractors is a hard problem – and you might say that we have not completely succeeded, depending on your view of Vietnam, Iraq, and Afghanistan.

But, at least in terms of weapons design and procurement, we have made some progress in developing a set of highly skilled independent engineers – as argued by Larry Candell in the latest issue of Harvard Business Review (now on-line, but there's an awkward page break; here's an alternative link – look for idea #3).

Larry is an interested party – from a leadership role at Lincoln Labs, he explains that this organization provides an independent design and evaluation capability that is not government bureaucracy and definitely not a profit-oriented defense contractor. (Disclosure: Lincoln is part of MIT, where I work.)

Irrespective of what you think about the defense business, Larry's proposal vis-à-vis finance is intriguing. He thinks the government should set up its own arms-length labs (or sponsor nonprofit research organizations to do the same) that would concentrate on testing financial derivative products in test bed-type settings.

This would not, of course, be the same as trading in real markets. But with today's computer resources and plenty of unemployed finance talent at hand, it should be possible to develop individual people and a broader organizational capacity able to test the effects of various kinds of derivatives on customers, as well as on overall financial system stability.

The proposed National Institute of Finance (NIF) would have similar broad goals – and the National Institutes of Health is an appealing model – but as NIF is currently proceeding with industry-backing (e.g., Morgan Stanley, Bank of America), we should be skeptical.

We definitely need independent derivatives experts who can be called to testify before Congress or work in an administration. They must have a deep understanding of financial markets, as well as hands-on experience with products that are dangerous to our economic health.

It would be great if people from hedge funds or other financial institutions were willing to step forward and play this role – many of our best experts don't actually work for the big banks. But while these independent people criticize eloquently the major broker-dealers in private, very few of them are willing to step forward in public.

Initial responses (e.g., by Stefan Stern, writing in the Financial Times) suggest that Larry's idea may get some traction.

*By Simon Johnson*

*This piece appeared, in an edited form, earlier today on the NYT's Economix; it is used here with permission. If you wish to reproduce the entire post, please contact the New York Times.*

## Bankers and Athletes

James Kwak | 07 Jan 2010

Bill George, a director of Goldman Sachs, defending the bank's compensation practices, said this: "The shareholder value is made up in people and you need the people there to do the job. If you don't pay them for their performance, you'll lose them. It's much like professional athletes and movie stars."

The idea that the level of inborn talent, hard work, dedication, and intelligence you need to be a banker is even remotely comparable to that of, say, NBA basketball players is ridiculous. But leaving aside the scale, there are some similarities. Most obviously, athletes on the free market—those eligible for free agency—are overpaid. John Vrooman in "The Baseball Players' Labor Market Reconsidered" (JSTOR access required) goes over the basic reasons, but they should be familiar to any sports fan. There is the lemons problem made famous by George Akerlof: if a team gives up a player to the free agent market, it probably has a reason for doing so. There is the winner's curse common to all auctions: estimates of the value of players follow some distribution around the actual value, and the person who is willing to bid the most is probably making a mistake on the high side.

Another common factor is the mistake general managers make in overpaying for luck. Take any group of .265 hitters, give them 450 at bats, and a handful will hit .300. On the free agent market, they will be paid like .300 hitters, especially if they are young and they do not have a long history of hitting .265 behind them. This is the exact same as one bank making a huge offer to a trader from another bank who just had a great year.

For another, the apparent productivity of a player in a team sport is largely due to his team and cannot simply be reproduced individually. John Vrooman in "The Baseball Players' Labor Market Reconsidered" cites the sad case (for New York Mets fans, of which I am one) of Bobby Bonilla, who racked up spectacularly numbers hitting ahead of Barry Bonds for the Pirates, but flopped with the Mets. The same trader who makes big profits at Goldman based on its low cost of funding, sterling reputation, and tremendous client connections will not necessarily do nearly as well on his own.

Finally, while there is a strong relationship between pay and past performance, there is only a loose relationship between pay and future

performance. Look at the teams that won the World Series between 2000 and 2009: Arizona Diamondbacks, Anaheim Angels, Florida Marlins, Boston Red Sox, Chicago White Sox, St. Louis Cardinals, Boston Red Sox, and Philadelphia Phillies. Only the Red Sox were among the sport's traditional big-market teams. Yes, there is a correlation between payroll and number of wins (the Yankees do win the World Series more than other teams), but the random factors play a big role as well.

So yes, bankers are like athletes. Their individual contributions are overrated relative to their supporting environments; they are overpaid; they are paid based on where they randomly fall in the probability distribution in a given year; and paying a lot for bankers is no guarantee that your bank will be successful in the future. Team sports, like banking, are an industry where the employees capture a large proportion of the revenues. And one with negative externalities, like upsurges in domestic violence around major sporting events. Neither one should be a model for our economy.

*By James Kwak*

## Countdown to January 18: Goldman's Bonus Day

Simon Johnson | 08 Jan 2010

Sources say that Goldman Sachs' bonuses will be announced on Monday, January 18, and actually paid sometime between February 4 and February 7. In previous years, the bonuses were paid in early January – but the financial year shifted when Goldman became a bank holding company.

For critics of the company and its fellow travelers, the timing could not be better.

Anxiety levels about the financial sector are on the increase, even on Capitol Hill. The tension between high profits in banking and stress in the rest of the economy becomes increasingly a topic of discussion across the nation.

And you are hard pressed to find any government official who has not by now woken up – in private – to the dangerous hubris of big banks. To add insult to injury (and many other insults), the Bank for International Settlements is holding a meeting to discuss excessive risk-taking in the financial sector; according to CNBC Thursday morning, Lloyd Blankfein of Goldman and Jamie Dimon of JPMorgan Chase were invited but did not show up (they really are very busy).

The smart strategy for Goldman in this context would be to pay no bonus for 2009 (in cash, stock or any other form), but this is not possible for three reasons.

1. Goldman would need to make a credible commitment to employees to "take care of them next year". But any legally binding commitment would be as good as a cash bonus (who knows, they could even be traded over-the-counter). And any verbal promises would be completely noncredible – among other things, Goldman cannot know for sure how the coming perfect storm will play out: the supertax on bankers in Europe, Sheila Bair's good idea of tying deposit insurance premiums to the risk in banks' compensation structures, Hank Paulson's memoir on February 1, Chris Dodd's resignation and the collapse of any meaningful Obama financial reform – allowing the Democrats to wake up to how they can run hard against Big Finance in 2010, etc. And besides, how much would you trust your boss at Goldman? The old culture there is gone.

2. For all their communication blunders in recent months (internally they wince at “God’s work”), the responsible executives think they can hide the size of the bonuses or talk more about how stock and option grants encourage the right kind of behavior or put in some sophisticated clawback language. Some of the best lawyers in the country are working very hard on this question, but it’s all for naught. The headline bonus number will be at least \$20bn and if they try to hide this with sophisticated mumbo-jumbo, that will only bring greater attention and spread the pain over many news cycles as we run through denials, further exposures, more denials, and damning details. When you’re in a hole, stop digging – Goldman is talking with top PR consultants; perhaps they should bring in Tiger Woods to advise on this point.
3. The most important reason is also Goldman’s greatest weakness: throughout the organization, people really think they are worth the money. But remember these facts and keep track of how many times you hear them repeated: Goldman Sachs essentially failed in September 2008; it was saved by extraordinary and unprecedented government efforts at the end of September and subsequently (particularly through its conversion to a bank holding company, which gave access to the Fed’s discount window); partly this treatment was shaped by the special favor with which Hank Paulson viewed Goldman (documented in nauseating detail in Andrew Ross Sorkin’s *Too Big To Fail*); and the strategy of allowing Goldman to recapitalize through taking huge risk with an unconditional government guarantee in 2009 only makes sense if they use the proceeds to boost their capital – not if they pay out massive bonuses. In any reasonable economic analysis, the entire bonus pool at Goldman should be paid – with gracious thanks – to the government.

The refrain that will be repeated by Goldman executives is: We need to pay the bonuses in order to keep the best people. But think about this like a stockholder for a moment – where exactly would these people go to work if this year’s bonus is set at zero?

Among the Casino Banks, Goldman is currently the best place to work and, looking forward, that’s where folks will make the most money. Hedge funds are not hiring in large numbers – most of the new financial sector jobs are at the other Too Big To Fail firms, who are now bringing people back (naturally).

Goldman's management should come to its senses and pay no bonuses of any kind to anyone; no good people would leave. Fortunately, while the executives who run Goldman are smart, they are not that smart. The bonuses they announce on January 18 and pay in early February will become the rallying point for real reform.

*By Simon Johnson*

## The Costs of “Extend and Pretend”

James Kwak | 08 Jan 2010

For months now, [Calculated Risk](#) has been criticizing the policy of “extend and pretend”—the practice of pretending that real estate loans are still worth their full value, making modifications so that borrowers can avoid going into default, so that banks don’t have to recognize losses on their assets. Here’s [one story](#) about “zombie buildings”—office buildings, in this case.

Alyssa Katz has a great article in [The American Prospect](#) about extend and pretend when it comes to multi-unit residential buildings, focusing on New York City. Expensive condo towers are now “see-through” buildings (so named because you see through the glass walls right through the empty floors—a phenomenon I first saw in 2001, after the Internet bust, along Highway 101 on the San Francisco Peninsula). Another problem is apartment complexes that were bought by private equity firms and flipped to developers during the boom with plans to evict the low-rent tenants and replace them with high-rent tenants; the high-rent tenants never arrived, the developers can’t make their loan payments, and no one is maintaining the buildings for the remaining tenants. (And no one is saying that property developers have a moral obligation to pay their debts rather than turn their properties over the bank.)

One of the underlying problems is that developers (or the banks that inherited their properties) have an incentive to hang on and hope for a return to prosperity that will deliver the promised condo buyers or high-rent tenants—in other words, betting on another boom. The alternative is selling the properties to someone who will convert or restore them to the type of housing that there is actually demand for—affordable rental units—but that means that someone has to take a loss, because an affordable building is simply worth less than one stuffed with investment bankers. Unfortunately, as Katz says, “With so many lenders at the brink of insolvency, the Treasury Department and the Federal Deposit Insurance Corporation (FDIC) appear to be in no rush to cause them further pain.” The lack of urgency was unwittingly confirmed by a Treasury spokesperson, who said, “The commercial real-estate market is something we’re watching closely, but it’s premature to discuss solutions.”

By James Kwak



## When a 79.9% APR Is Good?

James Kwak | 08 Jan 2010

Adam Levitin wrote an informative post on [Credit Slips](#) a couple of weeks ago; I missed it but it looks like no one in my RSS reader has mentioned it, so here goes. One provision of last year's credit card legislation limited up-front fees to 25% of the line of credit being offered. [First Premier Bank](#) currently offers a card with a \$250 credit line, \$124 in up-front one-time fees, a \$48 annual fee, and a \$7 monthly fee. Oh, and a 9.9% APR on purchases. That adds up to \$179 that gets billed immediately, and a total of \$256 over the first year—more than the credit line. Because this card will become illegal in February, they are test-marketing a new card that has a \$300 credit line, \$75 in up-front fees (to conform with the law; there could be a monthly fee in addition), and a 79.9% APR.

Levitin, using some assumptions, estimates the effective APR (including fees) of the current card at 112.3% and of the new card at 104.9%. So, a few observations:

1. The card with the 79.9% APR may actually be better for consumers. (It depends mainly on how long you use it, because you can then amortize the up-front fees; although once you've paid your bills for a year, presumably the goal is to establish credit to get a better card that doesn't have \$132 in ongoing fees per year.)
2. This may demonstrate the benefits of disclosure, since consumers may be deterred by the 79.9% APR. On the other hand, they may think that they are going to pay off the balance on time so the APR doesn't matter, but some of them will miss their payments because of misfortune or accident, and then they're stuck.
3. Most important, I think it shows the need for a Consumer Financial Protection Agency that has broad power to set new rules as the industry invents new tricks to get around the old rules. Last year's card bill was passed in an environment of violent antipathy toward the financial services industry that has already faded and is unlikely to return soon. So two years from now, when the dust has settled and the card issuers have figured out new ways to make money through deception, I don't have confidence that Congress will be able to respond appropriately. Last year's bill should have been stronger in various ways. Failing that, we need the CFPRA. Yes, it made it through the House, but as with health care and climate change, the Senate is likely to be tougher.

Should the new card exist? Maybe. If the pricing is transparent enough, so people understand the true cost of credit, then maybe they'll choose it for a year to establish a credit history. Maybe with transparency the new card will simply fail in the market. But even if some people want the card, I'm still skeptical that this would show a competitive free market. What kind of assumptions do you need to justify 79.9% as the real price of the risk the issuer is taking on, especially when the issuer has pocketed \$75 right off the bat (and, no doubt, is still charging late fees and the like)? The break-even default rate must be astronomical.

Appendix on price and marginal cost: The current First Premier Card has a \$3.95 fee to enable Internet access to your account and a \$7 fee for direct debits that you initiate over the phone or the Internet. Because, you know, mailing you bills and processing your checks is so much more cheaper than having you log in and pay using a computer. There are only two reasons I can think of for these fees, neither of them good: (1) Internet access and payment is something customers value, so we'll charge them for it (even though it lowers the issuer's costs), since in this segment they'll find it hard to find another provider; (2) Internet access and payment make it more likely that customers will pay their bills on time, so we want to deter that.

*By James Kwak*

## Money and Financial Reform

James Kwak | 09 Jan 2010

Last week, Ryan Grim and Arthur Delaney wrote a story for [the Huffington Post](#) about the difficulty of getting substantive reform through the House Financial Services Committee. They focus on two main things. First, because a seat on the committee is valuable for fund-raising purposes, the Democratic House leadership seems to have stacked it with vulnerable freshman and sophomore representatives from Republican-leaning districts, meaning there are a lot of Democrats who are either personally inclined to vote with the financial services industry or feel a lot of political pressure to do so. Second, a lot of committee staffers end up switching sides to work as banking industry lobbyists, and some of them then come back to be committee staffers, raising the usual questions about the revolving door. Barney Frank comes off as something of a hero; the idea is that Frank and his senior staffers are so smart and skilled that they can get effective legislation through despite the cards being stacked against them.

There are just a couple of things I wanted to point out.

“[Former committee lawyer Howard] Menell and others claim that nobody used to bat an eye when staffers went to K Street and back. It was all part of the pro-Wall Street consensus that developed during the boom years. By contrast, the new climate is creating tensions on the committee. When the financial system collapsed last fall, the bipartisan consensus on Wall Street came down with it.”

Today, we’re seeing a partisan battle over financial regulation, especially the CFPA: progressive Democrats are for, every single Republican is against, and the battle is over the “moderate” Democrats. In a sense, this is a good thing. Because for most of the past two decades, instead we had a bipartisan consensus that what was good for Wall Street was good for America, which made it completely unremarkable that legislation was being written by people close to the industry. Remember, the landmark bills that people point to—Riegle-Neal, Gramm-Leach-Bliley, the CFMA—were products of Clinton administration and of a Republican Congress with usually smaller minorities than the Democrats have now.

“Frank laments staff compensation: ‘We underpay public officials. Particularly the staff. [Lawmakers] get a certain degree of non-monetary compensation — psychic. You know, I get mentioned on “Gossip Girl.”’”

“Staffers get a good look at how the other half lives; they rub elbows with lobbyists both at work (in meetings or even on extravagant field trips) and off the clock, during ritualistic happy hours. Those who attend know the unspoken rule: don’t talk too much shop but bring plenty of business cards. The friendly social scene helps explain why there’s not much condemnation from staffers for colleagues who leave for higher pay.

“‘Everyone comes here to stand up for something they believe in, and at some point they go downtown to make money, and at some point someone they worked for draws them back [to the Hill],’ said a former staffer who works as a lobbyist. ‘It’s the running joke: a staffer gets married, you better go downtown! Spots open and one of the committee staffers has a kid. They’ll be moving downtown. Money is number one.’”

Individually, you can’t blame them. Private schools in DC cost around \$25,000 per year. A lot of these people graduated from law school with \$90,000 in debt (that’s around the average these days). But the fact remains that it’s a terrible system for the country. The money is in lobbying, and the environment erodes the qualms that people might have about it going in.

And it’s getting worse. In the 1960s, banking and law paid roughly like being a professor starting out; now they pay about 3-4 times as much, and the pay goes up much faster, too. This inequality problem we have is helping to erode our political system, among other things. Frank is right; we need to pay staffers more. I don’t see any way around it (except paying bankers, lawyers, and lobbyists less, and that’s not under public control).

*By James Kwak*

## Bernanke, Manager

James Kwak | 10 Jan 2010

There's a platitude repeated by most CEOs that their main job is not anything so mundane as making decisions, but "mentoring and supporting people" or something like that. Most of the CEOs who repeat this are mediocre at best at mentoring or supporting people, since the key people for any CEO are not the people who work for him or her, but the members of the board of directors. But the truism that is still true is that when you are head of a large organization, you can't do everything yourself, and your real impact is made through the people you hire, promote, and don't fire.

In October, Ben Bernanke named Patrick Parkinson director of the Division of Bank Supervision and Regulation. Who is Patrick Parkinson?

EB at Zero Hedge has the history in ten years of extended quotations. Here's one example from 2005:

"[Transactions between institutions and other eligible counterparties in over-the-counter financial derivatives and foreign currency] are not readily susceptible to manipulation and eligible counterparties can and should be expected to protect themselves against fraud and counterparty credit losses."

Here's another from July:

"One of the main reasons the credit derivatives market and other OTC markets have grown so rapidly is that market participants have seen substantial benefit to customizing contract terms to meet their individual risk-management needs. They must continue to be allowed to bilaterally negotiate customized contracts where they see benefits to doing so."

Now, it's plausible that the benefits to parties of certain types of transactions may outweigh the costs of those transactions to society at large. But to say that parties must be allowed to negotiate customized contracts simply because they want to is frivolous. (Insert analogy to illegal drug sales here.)

So Parkinson was another mini-Greenspan—what's wrong with that? Nothing, really—except that Bernanke promoted him, now when we need someone new to take bank supervision seriously.

Where's the change?

*By James Kwak*

## Obama and FDR

James Kwak | 11 Jan 2010

Kevin Drum found a great quotation from FDR and what he thought of bankers, monopolists, and speculators. It's so good he deserves to have you go there and read it.

Drum's point is that while health care may have required conciliation and moderation, "When it comes to financial regulatory reform, Obama needs to let us know whose side he's on." So far Obama has played the peacemaker, the reasonable man in the middle, the man who bridges divides. "My administration is the only thing between you and the pitchforks," he said last March; note that he brought up the pitchforks, but positioned himself as the center, holding back the crazies.

With financial regulation, there is no powerful force in Washington pushing for major change; Obama's own Treasury Department is pushing for moderation. The closest thing the common man has to an advocate in Washington is Elizabeth Warren, and her job is chair of the TARP Congressional Oversight Panel. So financial regulation has become a negotiation between the centrists at Treasury and the banking lobby, which is an unlikely recipe for change. I'm no Axelrod, but it seems to me that taking a stand would be good politically, too; with unemployment likely going to be high in November, taking the side of the man in the street against the man in the glass tower couldn't hurt.

There's another contrast to draw with FDR. This is what Arthur Schlesinger had to say about the FDR administration in 1933 in *The Coming of the New Deal* (p. 444):

"No business group was more proud and powerful than the bankers; none was more persuaded of its own rectitude; none more accustomed to respectful consultation by government officials. To be attacked as antisocial was bewildering; to be excluded from the formation of public policy was beyond endurance. When one remembered both the premium bankers put on inside information and the chumminess they had enjoyed with past Presidents and Secretaries of the Treasury, the new chill in Washington was the cruelest of punishments."

Obama came into office hoping to pick up the mantle of FDR. It's not too late.

*By James Kwak*

# The Case For A Supertax On Big Bank Bonuses

Simon Johnson | 11 Jan 2010

The big banks are pre-testing their main messages for bonus season, which starts in earnest next week. Their payouts relative to profits will be “record lows”, their people won’t make as much as in 2007 (except for Goldman), and they will pay a higher proportion of the bonus in stock than usual. Behind the scenes, leading executives are still arguing out the details of the optics.

As they justify their pay packages, the bankers open up a broader relevant question: How much bonus do they deserve in this situation? After all, bonus time is when you decide who made what kind of relative contribution to your bottom line – and you are able to recognize unusually strong achievement.

Seen in these terms, the answer is easy: people working at our largest banks – say over \$100 bn in total assets – should get zero bonus for 2009.

The big bank executives make three points in favor of paying bonuses for 2009.

1. If the bonuses are not paid, people will leave our major banks. It’s unlikely that many good people will leave, but if they do move to smaller institutions that are not Too Big To Fail, that’s good for the rest of us.
2. Big banks made these profits fair-and-square, so the bonuses belong to the workforce. This is wrong at two levels (a) the profits in 2009 (and 2008) were solely the result of massive government intervention, designed at saving and recapitalizing big banks, and (b) the recapitalization part of that strategy only works if the profits generated are retained - not if they are paid out.
3. You cannot now tax the bonuses for 2009 without violating all the norms of reasonable taxation – i.e., that it not be retroactive, not be confiscatory, and not mess seriously with incentives. Ordinarily, these are good arguments. But today’s circumstances are so egregious that we need to take highly unusual steps. The banks and their key employees are so far from understanding what they did wrong, they don’t even have a framework within which they can understand what they need to do right going forward. This industry needs a wake-up call.

The administration should immediately propose and the Congress must at once take up legislation to tax the individuals who receive

bonuses from banks that were in the Too Big To Fail category – using receipt of the first round of TARP funds would be one fair criterion, but we could widen this to participation in the stress tests of 2009.

The supertax structure being implemented in the UK is definitely not the right model – these “taxes on bonuses” are being paid by the banks (i.e., their shareholders – meaning you, again) and not by the people receiving the bonuses.

Essentially, we need a steeply progressive windfall income tax – tied to the receipt of a particular form of income. This is tricky to design right – but a lot of good lawyers can get cranking.

And we should be honest about the distortionary effect that even proposing such legislation will have on incentives. It will send a signal that income generated by working at big banks is less secure – all employees of these banks should be looking over their shoulders; sooner or later, the Internal Revenue Service is coming. This is particularly relevant for 2010, which looks set to be another bumper year for the financial sector.

At this stage, tilting the playing field towards smaller participants in financial markets is not a bug, it's a desperately needed feature.

*By Simon Johnson*

# Leading Indicator of Me

James Kwak | 11 Jan 2010

If I ever go to another school, you should run away from it as fast as you can. That is the practical implication of [Felix Salmon's post](#) a few days ago rounding up arguments for why you should not get a Ph.D. in the humanities or go to law school.

Thomas Benton's article, "[Graduate School in the Humanities: Just Don't Go](#)," nails the basic reasons why I went to UC Berkeley nineteen years ago: excitement in the subject, a history of high grades, the comforting structure of academia, romanticization of university life, and no practical application of academic skills. (See the six bullets halfway down the article.) When I left Berkeley in 1997, I could not get an academic job that I wanted ... and the rest is history, I guess. If you do get a Ph.D. in the humanities these days, the numbers are even more heavily against you than they were then. First, American universities as a whole are shifting from tenure-track jobs to untenured adjunct positions; second, within universities, the jobs are shifting from the humanities into vocational fields like accounting and nursing. The ongoing bloodbath in state finances is only making things worse, since most of the good universities in the country are public.

Law school (where I am now) is probably a better bet, but it could be getting worse. This is the money chart, from the National Association of Legal Professionals (commentary by Bill Henderson [here](#); on the reasons for that distribution, see Henderson [here](#)):

(Those are starting salaries after graduation, not current salaries.) There are some caveats here. 9.6% of the people in that distribution are judicial clerks, which means they will probably be leaving those jobs in one-two years, and many of them will move from the left-hand mode to the right-hand mode (which, these days, is around \$170,000). 5.4% of them are public interest lawyers, which means they may have been planning to have a modest income all along—but that doesn't change the fact that they have a modest income and, most likely, a lot of debt. (Some might be independently wealthy, but [this post](#) indicates that the proportion of public interest lawyers is actually higher among people with high debt loads than among people with no debt. Which also implies, indirectly, that the people who have money most want to make more of it.)

In other words, law school is no guarantee that you'll make enough money to pay off \$45,000 of tuition per year. And the trends, though weaker than for the humanities, are probably negative. That right-hand mode is based on the ability of top-tier, big-city law firms to bill out associates at outrageous rates. The trend is for big corporations to refuse to pay those rates for people right of law school, which is putting pressure on the system as a whole. (I don't think this trend has a ton of momentum behind it yet, though, so it may fizzle out.)

Of course, no individual's prospects are perfectly represented by the aggregate distribution. If you can get into a top school, your chances are better. When I went to Berkeley, the history department was essentially tied for the top position in the country, and I couldn't get a good job; however, one of my closest friends in graduate school got tenure *early* at Harvard and another friend recently won a MacArthur "genius" grant. But nothing is guaranteed. At the very top law schools, if you want to be in that right-hand mode, you will probably get there. But you may not stay there for long enough to pay off your debts. At one school, although about 70 percent of grads go to law firms (most of the rest to public interest or government work), by five years after graduation slightly less than half are still at those firms. Job satisfaction is higher among the people not at law firms, not surprisingly.

Personally, I think law school is great: the classes are moderately interesting, the people are great, it's super-non-competitive (at least at Yale), you can do whatever you want, ... So I wouldn't necessarily counsel people not to do it. But prospective students should know what the numbers are, they should be aware of how much debt they're taking on, and they should know what type of lifestyle it takes to make the whole thing pay off financially. And, as always, they should watch out for optimism bias. It's easier to say that you will be the person working late nights through your late twenties and early thirties than to actually do it.

*By James Kwak*

## My Last Post on Ben Bernanke

James Kwak | 11 Jan 2010

His confirmation, that is. I summarized most of my position in Foreign Policy, which asked me to lay out the anti-confirmation argument. My reasons overlap with Simon's but are not identical—I think Simon worries about cheap money and asset bubbles more than I do. I was originally not particularly motivated by the anti-Bernanke campaign, because I didn't think Obama would appoint anyone better, but as Russ pointed out, whether Bernanke should be confirmed and what the alternative is are two separate questions.

Whom would I pick? I certainly don't know the candidates well enough to make a good choice. But the first thing I would say is that the Federal Reserve chair does not need to be Superman. The Federal Reserve Board of Governors is a board, and while the chair is important, he or she should really be the first among equals. You want someone who will push the Board in a certain direction, but the chair can draw on the experience and skills of the other board members and the staff, who are technically very competent. The idea that the chair must be Superman seems to be a product of the Greenspan era, and we project it back onto Volcker because of his success in fighting inflation in the early 1980s. And it's a bad idea, just like searching for a savior CEO. In this context, I think it's limiting to insist that the nominee have experience on the board, or have government experience, or be a prominent academic, or anything in particular.

For a rough parallel, think of John Roberts. When he joined the Supreme Court, he was by definition the least experienced of the bunch—yet President Bush made him chief justice, and no one objected that he was not competent enough for the job (the objections were over his anticipated policies). In short, the nominee must have intellectual heft and people skills, but otherwise President Obama should feel free to pick someone on the basis of his policies. It's no accident that Ronald Reagan picked an ardent free marketer back in 1987.

My other observation is that the bench on the progressive side is pretty thin, because there has been a de facto consensus around central banking in the past two decades. That is, everyone seems to think that inflation is more important than full employment, and most people at the Fed have shared the pro-innovation/anti-regulation stance of Greenspan and Bernanke, and hence the emphasis on monetary policy as opposed to

regulation. (I'm not an experienced Fed watcher, so I'm sure I'm overlooking someone in those generalizations.) But if Obama wanted a progressive choice (which he doesn't, but just as a hypothetical), there doesn't seem to be an obvious one.

But anyway, after all that lead-up, what about Paul Krugman? I think he's said he doesn't want the job (or was it Treasury Secretary that he didn't want?), but I'm sure Obama is a hard person to say no to. Or Brad DeLong? He's clearly smart and knowledgeable, and I like what he says about inflation and deficits. Whether either of them has the people skills to be chair of the Fed I have no idea. But I don't think we should be confining ourselves to previous board members, especially since this is a fruitless intellectual exercise, because Bernanke will be confirmed sooner or later.

*By James Kwak*

## Bank Tax Arrives

Simon Johnson | 12 Jan 2010

The Obama administration tipped its hand today – they are planning a new tax of some form on the banking sector. But the details are deliberately left vague – perhaps “not completely decided” would be a better description.

The NYT's Room for Debate is running some reactions and suggestions. The administration is finally getting a small part of its act together – unfortunately too late to make a difference for the current round of bonuses.

We know there is a G20 process underway looking at ways to measure “excess bank profits” and, with American leadership, this could lead towards a more reasonable tax system for finance. In the meantime, my point is that taxing bonuses – under today's circumstances – is not as bad as many people argue, particularly as it lets you target the biggest banks.

*By Simon Johnson*

## The Financial Crisis Inquiry Commission: Ready For A Breakthrough

Simon Johnson | 12 Jan 2010

The Financial Crisis Inquiry Commission (FCIC) holds its first public session on Wednesday. When the FCIC was established in May, the prevailing wisdom was that the hearings and final report would be dry and rather inconclusive.

But the debate around Big Banks has started to shifted markedly, particularly in recent weeks. Anger about bonuses is increasingly expressed by the most mild-mannered policy experts. The administration itself is proposing some sort of excess profits tax on the biggest banks. And – most important – our top bankers have their tin ears prominently on display.

In the Daily Beast, I suggest exactly how the Commission can put this moment to productive use. The point is to find for rather dull and difficult technical material to become names, dates, and numbers that catch the popular imagination – and provide a genuine warning. The most obvious and reasonable way to do this is by drilling down into the details of the Wall Street compensation system, then and now - the more you dig, the more you understand why we are heading for trouble.

*By Simon Johnson*

## Feed Problems?

James Kwak | 12 Jan 2010

I've gotten a few messages that our feed is not working properly. And, it occurs to me that I haven't been getting email updates for the past couple of days.

The default feed produced by WordPress (<http://baselinescenario.com/feed/>) is working fine, and I can read the blog fine in Google Reader. But the Feedburner version (<http://feeds.feedburner.com/BaselineScenario>), which generates the emails, is stuck at January 8. I'll look into it, but if you have any diagnostic details or suggestions let me know below.

(I suspect it is related to my having changed the number of items that go into the feed from 15 to 200; I was trying to figure out a better way to convert the blog to PDF, and that was one of the steps. I reset it this morning, so that may fix it.)

**Update:** Forcing Feedburner to ping the default feed worked; the Feedburner feed is up to date now. I'll watch it to see if it picks up the next post or not.

**Update 2:** It did. I'm guessing that email subscribers will get an email tonight. (Of course, most of you aren't here to read this.)

*By James Kwak*

## More from “The Lion”

James Kwak | 12 Jan 2010

In the short days between Christmas and New Year's, *BusinessWeek* published an interview with Paul Volcker conducted by Charlie Rose headlined “The Lion Lets Loose.” Rose asked him why the U.S. economy has fallen behind in some areas, such as manufacturing. Here's the segment:

### “How did that happen?”

“What happened is our best and brightest got attracted to Wall Street. You've read about those big bonuses. These are generalizations, but I do think that the pull of Wall Street on bright young people, ambitious young people, has been tremendous.”

### “Will it change?”

“I think we're in the process of change now. Wall Street hasn't got quite the glamor that it had a few years ago.”

### “Yes, but I hear bonuses are coming back.”

“Well, I hope you'll get more competition on Wall Street and get some reforms, and profitability won't seem quite so great. At one point, Wall Street had almost 40% of all the profits in the country. And, you know, its contribution to the welfare of the country does not approach 40%. Something's out of line here.”

I agree with everything there, but note that Volcker says “I *hope* you'll get more competition on Wall Street.” Where will that competition come from? Right now we have less competition than before the crash. Simon and I are obviously in favor of breaking up large Wall Street firms. But if policymakers are leaving that off the table, they should have another suggestion for increasing competition. This was tried with the credit rating agencies several years ago, with not very promising results, and the barriers to entry in investment banking (people, algorithms, machines, client relationships, brand, size of balance sheet) are considerable. What's the right mechanism for encouraging the creation of newer, smaller investment banks that won't simply be bought up by the big ones? Could you tax the big ones and use the proceeds to capitalize a new generation of competitors?

Volcker also thinks that simply paying bonuses in stock is not the answer to incentive problems. He doesn't spell this out in great detail, but it seems the problem for him is "a lot of criteria that he's going to manipulate to his advantage." That is, the problem is how you calculate the bonus in the first place, because that's where the incentives come in. I've already put forward my suggestion: calculate the bonuses on the basis of results over a long time period, not just one year; make it long enough, and you could even pay the bonus in cash, because the long term has already happened.

*By James Kwak*

## Drill, Baby, Drill: Reviewing The Advice To The Financial Crisis Inquiry Commission

Simon Johnson | 13 Jan 2010

The NYT has a collection of potential questions for the Financial Crisis Inquiry Commission (FCIC) to ask four of the country's leading bankers today.

Some of the proposed questions are technical or even philosophical. These are interesting, but hardly likely to be effective.

I like where Yves Smith is going: what kind of bonuses were paid for trades on which firms ultimately lost money? Bill Cohan and David Walker, coming from very different perspectives, are also pushing on issues related to compensation structure in general and bonuses in particular.

The real issue, of course, is the nature of the risk system itself. But this is a big abstract question – and not suited to these kind of hearings. The Commission needs to find concrete issues that people can relate to much more broadly, and bonuses are very much in the line of fire. The fact that the 2009 bonuses are already in the works – and eerily, but not coincidentally, parallel to the 2007 bonuses – is going to make this hard for the bankers to spin.

Serious debate is just beginning – drill down into how bankers at Too Big To Fail firms really pay themselves, and you will be amazed at what you start to see more clearly.

*By Simon Johnson*

## “Appalled, Disgusted, Ashamed and Hugely Embarrassed”

James Kwak | 13 Jan 2010

No, that's not someone talking about the banking industry. That's Howard Wheeldon of BGC Partners (a brokerage firm) responding to Adair Turner's statement last September that "Some financial activities which proliferated over the last 10 years were socially useless, and some parts of the system were swollen beyond their optimal size." (Turner is head of the FSA, the United Kingdom's primary bank regulator.) That's from a recent profile of Turner on [Bloomberg](#).

“How dare he?” Wheeldon now says. ‘Markets will decide if something is too big or too small. It’s not for an individual, however powerful, to slam and damn nearly 1 million people.’”

Do we really need to point out that markets don't always make the right decisions? Markets didn't break up Standard Oil or AT&T—people did. And how is it wrong for public figures to be publicly stating their beliefs about what the objectives of public policy should be?

But the point of this post isn't to single out another free-market zealot who apparently doesn't think about the words he is saying. It's to talk about John Paulson and Malcolm Gladwell.

On pages 179-82 of Greg Zuckerman's book *The Greatest Trade Ever* (in the pre-publication version that Simon got for free), he describes how Paulson helped design CDOs so that he could short them (by buying CDS protection on them). The issue was that Paulson wanted to place as big a bet as possible against the housing market, and he wanted that bet in as concentrated a form as possible. He wanted to expand the set of assets that he could buy insurance on, and make those assets as toxic as possible. He was even willing to buy the equity (lowest-rated) slice of the CDO, so that the high returns on the equity would help pay for the CDS protection until the roof caved in. So his team would select mortgage-backed securities that they wanted to be bundled into a CDO; the bank would modify his selections, get the CDO rated, and then find counterparties willing to insure it so that Paulson could buy insurance from them. Some banks refused to participate; others, including Goldman Sachs and Deutsche Bank, went along.

Is this transaction socially useful? And is it ethical?

The main purposes of the financial system are processing payments and financial intermediation (conversion of savings into investment). Clearly neither one is happening here—at least not via the CDS transaction, which does not provide credit to anyone in the real economy. However, there's another defense you can fall back on, which is that this transaction provides additional liquidity. Because it allows people to express their views about particular securities (mind you, securities that didn't exist until Paulson got involved), it improves price discovery; and because more transactions are taking place, it makes it easier for investors to get in and out of positions (again, that argument is weakened since the transaction is just creating new, illiquid securities, not increasing liquidity for existing securities). On balance, though, I'd say the social utility is pretty small at best. It's helping Paulson short the housing market, which should have the salutary effect of putting downward pressure on the bubble, but only by allowing someone else to go long on the housing market, which has the opposite effect.

Still, though, I wouldn't say Paulson was doing anything unethical. His job is to make a lot of money, and he was looking for the most direct way to do it. The more interesting question applies to the bankers in the middle.

Compare this to two other transactions. In the first transaction, a banker sells his client a share of stock in an IPO. In that case, there is definite win-win potential: the company needs capital and is willing to pay a high (expected) rate of return and the investor wants that high rate of return. Although you can quibble about what the stock should be priced at, there's no inherent conflict of interest in raising money for a company and selling its shares to investors.

In the second transaction, a broker convinces his client to buy a share of stock on the secondary market. Now this is a zero-sum transaction; if buying it is a good deal for one person, selling it is a bad deal for someone else. But here the broker is only representing his client; the share will be bought on an exchange, and he has no idea who is going to sell it. So while there is certainly room for unscrupulous brokers who convince clients to buy lousy stocks solely for the commissions, there is no inherent problem with this situation.

In the Paulson example, though, the same bank is working with Paulson to create a toxic CDO and convincing its client on the other side to buy or insure that CDO. Not only is it a zero-sum transaction, but it's a zero-sum transaction between the bank's clients. (This applies to many

derivatives transactions, of course.) Now plausibly this could be in the interests of both sides, depending on their existing risk profiles; if Paulson owned billions of dollars of beachfront property in Florida, he might be shorting real estate as a hedge, and the investors might want to be long real estate because . . . well, who knows.

In any case, there isn't anything necessarily unethical about this practice. If the bank clearly describes the transaction to the investor, and discloses that it has a client taking the other side (who, in this case, helped design the transaction), then the investor can make his own decision about it. Basically, it's like placing a bet with a sports bookie. You know that the bookie is taking the same volume of bets on the other side (that's how the line is set), and you know not to trust him if he tries to talk you into a bet, because you know he doesn't have your interests in mind; he just wants his cut.

But what did the banks say? If they said, "You're betting against Paulson, he's pretty smart, you're pretty smart, let the best man win," then that's fine. But if they said, "This guy Paulson, he's nuts, we all know housing isn't going to go down, just take his money," then that's a problem, at least in my opinion. Because if you're a broker and you're connecting two parties in a deal, you shouldn't be arguing to both of them that they are getting the good end of the deal, even if it's two different people at the bank doing the arguing. So this is maybe something for that Financial Crisis Inquiry Commission to look into: how were these things sold?

In the long run, the simplest solution would be for everyone to realize that their banks are not on their side, and that the famous "long-term greed" of Goldman is gone forever, replaced by the more plebeian short-term greed.

(Malcolm Gladwell will have to wait for another post.)

*By James Kwak*

# United States Health Care Spending

James Kwak | 13 Jan 2010

The vast discrepancy between what we spend on health care and what every other prosperous (or not-so-prosperous) country spends on health care—and the little good it does us—is so well-known that it's not going to change any minds when it comes to health care reform. Opponents of reform have come up with their rationalizations (more spending on technology, someone has to subsidize cheap drugs for the rest of the world, etc.), some of which contain grains of truth. But even if people aren't listening any more, that doesn't make it any less true.

Ezra Klein brings us the latest reminders. Here's the most amazing graph from National Geographic:

That's a clever trick, putting the outlier above the title of the chart. I'll have to try it sometime.

*By James Kwak*

## **“I Do Not Blame The Regulators”**

**Simon Johnson** | 14 Jan 2010

Jamie Dimon has all the best lines. In May 2009, he told JPMorgan Chase shareholders that 2008 was probably “our finest year ever.” That was before he thought about profits for 2009.

And today he told to the Financial Crisis Inquiry Commission, “I want to be clear that I do not blame the regulators. The responsibility for a company’s actions rests with the company’s management” (p. 9).

This is true enough – and something to reflect on during bonus season. But at a deeper level, the crisis of 2008-09 and our continued dangerous financial system are very much the fault of our regulators.

Bank executives are supposed to make money; Jamie Dimon has a fiduciary responsibility to his shareholders. It is not his responsibility to prevent bankers from taking over the state or to ensure system stability. He pursues profits – and rent extraction from the government.

It is the government’s responsibility to prevent people like Jamie Dimon – who is very good at his job – from creating massive social costs. The failures here – and they were colossal – were on the part of the people who ran the Federal Reserve, the Treasury, and associated agencies over the past 20 or so years.

Hopefully, these people will soon appear before the Commission.

*By Simon Johnson*

## The Citi Never Weeps

Simon Johnson | 14 Jan 2010

On the first day of the Financial Crisis Inquiry Commission, Phil Angelides demonstrated a gift for powerful and memorable metaphor: accusing Goldman Sachs of essentially selling defective cars and then taking out insurance on the buyers. Lloyd Blankfein and the other CEOs looked mildly uncomfortable, and this image reinforces the case for a tax on big banks – details to be provided by the president later today.

But the question is: How to keep up the pressure and move the debate forward? If we stop with a few verbal slaps on the wrist and a relatively minor new levy, then we have achieved basically nothing. We need people more broadly to grasp the dangerous financial “risk system” we have created and to agree that it needs to be dismantled completely.

One way to do this would be for the Commission to call key people from Citigroup to testify.

This would not be as part of a large panel with other firms. This would be a drill down into the history, structure, and attitudes involved in building what became the country’s largest bank – and then in driving it into the ground. My full proposal is on the [Daily Beast today](#), but in summary I would question Vikram Pandit and Chuck Prince at length and then pull in Sandy Weil and Robert Rubin.

This is not about the individuals; it’s about the system. But the only way that broader mainstream opinion will change is if it sees and hears from the people who thought they had everything under control. And – let’s face it – Citi has been at the center of all major international financial crises over the past 30 years; its alumni have top positions in our administration; and no one thinks it is a well-run organization.

It’s the human dimension of big bank hubris that will grip the popular imagination. That and the great fortunes they accumulated at your expense.

*By Simon Johnson*

## The Obama Financial Tax Is A Start, Not The End

Simon Johnson | 14 Jan 2010

The flurry of interest this week around ways to tax Big Banks is important, because officials in the US are – for the first time – recognizing that reckless risk-taking in our banking system is dangerous and undesirable.

But the possibility of a tax on bonuses or on “excess profits” that are large relative to the financial system should not distract us from the more fundamental issues.

Mr. Bernanke and Mr. Geithner need to admit that the Federal Reserve and New York Fed played a key role in creating this problem through misguided policies. They were part of the regulatory failure, not independent of it. When you keep interest rates very low and let balance sheets explode under your watch, we’ve seen how things fall apart.

As long as Bernanke and Geithner do not concede this point, they send a clear message to banks throughout the US and around the world that they can load up on risk again, and hope to profit – personally and professionally – from Mr. Bernanke’s next great credit cycle.

Yes, a new tax on these profits will raise money. But it will not prevent a major collapse in the future. There is no use discussing tough regulation when the previous regulators are still in charge, and they refuse to admit they were part of a system which egregiously failed. Mr. Bernanke’s speech at the American Economic Association 10 days ago was a big step backwards for those – such as Tom Hoenig, head of the Kansas City Fed – who want to send a message that there is a new regime in place to stop future crises.

One view of regulation is that you can adjust the rules and make it better – with each crisis we learn more, so eventually we can make it perfect. This appears to be the current White House position – there is even mention of the US becoming “more like Canada”, in the (mythical) sense that we’ll just have four large banks and a quite life.

Another view is that the current complicated rules obfuscate and make it easier for the financial sector (sometimes with collusion of regulators) to game and hide risk. Successive failures of regulators at large cost over the last three decades make it clear that fine tuning the system is not likely to work; every time you hear the “Basel Committee [of bank standard setters] is meeting today to discuss the details”, you should wince.

The ingredients for regulatory reform need to be simple and harsh.

1. Capital requirements at banks need to be tripled from the current levels so that core capital is 15-25% of assets.
2. Simple rules need to be in place to restrict leverage – the amount that banks, firms, and individuals can borrow (including in the form of mortgages).
3. Complex derivatives where risk is hard to measure need to have very high capital requirements behind them. It is not the regulators' job to work out the complex implications of derivatives, and we can't rely on banks or ratings agencies to do the job, so just keep it simple (and less profitable than today).
4. And, as the ultimate fail-safe, we need a hard size cap on major banks. All financial institutions have to be small enough so they can fail without causing major damage to the economy.

By all means, implement a sensible tax system that creates a punitive disincentive to size in the banking system – if you can figure out how to make this work. Most likely, the big banks will game this, like they have gamed everything else over the past 30 years.

But don't think taxes are the answer. We need to go back to simple, transparent regulation, and much smaller banks.

*By Peter Boone and Simon Johnson*

*An 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 text, please contact the New York Times for permission.*

## Thoughts on the Bank Tax

James Kwak | 14 Jan 2010

I'm in favor of the bank tax; what's not to like about extracting \$117 billion from large banks to pay for the net costs of TARP? But it's by no means enough.

Simon covered the main points earlier this morning, so I'll just add three comments.

1. Why \$117 billion? Because that's the current projected cost of TARP. But everyone realizes that TARP was only a small part of the government response to the financial crisis, and the main budgetary impact of the crisis is not TARP, but the collapse in tax revenues that created our current and projected deficits. So why not raise a lot more?

2. The tax isn't going to prevent a future financial crisis. And it isn't going to hurt any bankers, at least not very much. Basically it will get passed on to customers, and shareholders will take a small hit. The best thing about the tax is that it helps level the playing field between large and small banks. From Q4 2008 through Q2 2009, large banks had a funding cost that was 78 basis points lower than that of small banks, up 49 basis points from 2000-2007. Closing that gap could lead some of those customers, faced with lower interest payments on deposits or higher fees, to take their money elsewhere. (Of course, they are already getting lower interest and paying higher fees, so there may not be much of an effect.)

But the tax *isn't nearly big enough!* It's being calculated as 15 basis points of uninsured liabilities, calculated as assets minus Tier 1 capital minus insured deposits. 15 basis points is a lot less than 78 basis points. And if the FDIC cost of funds data are based on all liabilities (not just uninsured liabilities),\* then charging 15 basis points on uninsured liabilities only increases the overall cost of funds by about 7 basis points (at least in the administration's example). This doesn't come close to compensating for the TBTF subsidy.

The big banks will fight this, of course; they will claim that it simply increases the costs of doing business in America (although most individuals or firms can avoid those costs simply by switching banks). From a PR perspective, they would probably be better off smiling and handing over the money; if all they have to fear is a tax of 6 bp on total assets (again, in the administration's example), then they really have nothing to fear.

3. Because it's a flat tax with a cliff at \$50 billion in assets, it isn't going to provide an incentive for banks themselves to get smaller; Bank of America is not going to break itself into 45 pieces to avoid a 6 bp asset tax. If the tax had been graduated (bigger banks pay a higher percentage), then it might have had some small effect, although again the tax is probably way too small.

\* I couldn't tell in the fifteen minutes I spent on the FDIC web site—as I've often noted, what an awful web site! The Federal Reserve wins that contest hands down.

**Update:** Sorry, I just realized I didn't link to the Dean Baker and Travis McArthur study that has the 78 bp figure. Now I have (both above and [here](#)).

*By James Kwak*

## What Goes Around ...

James Kwak | 14 Jan 2010

"The user fee is a partial payment for the implicit guarantee it receives from Uncle Sam. The rationale behind such a fee is that since taxpayers are bearing an implicit risk on [the institution's] activities, it is reasonable that the federal government recoup fees to pay for that assumption of risk. The main advantage of such a fee is that it would help level the playing field between [the institution] and its fully private competitors."

What is "[the institution]"? It's Fannie Mae, and that's Stephen Moore of the Cato Institute testifying before Congress in 2000 in support of "a 'user fee' of 10 to 20 basis points on [Fannie's and Freddie's] debt to level the playing field between Fannie and competitors."

That's from Representative Brad Miller's op-ed pointing out that a small tax on debt issued by financial institutions that enjoy an implicit government guarantee is something that Republicans (and even the libertarians at Cato) used to be in favor of. The best reason for President Obama's proposed bank tax is not to punish banks or to recover the money that the government is likely to lose via TARP; it's to level the competitive playing field (although it doesn't do enough).

As Miller points out, the battle over Fannie and Freddie was a battle for profits between them and their competitors, in which both sides mobilized whatever Congressional support they could. As it turns out, the competitors were right: Fannie and Freddie did enjoy a government guarantee. Now those competitors are the ones with the government guarantee.

But does reminding Republicans that they used to support something help when you try to get them to support it now? Apparently not, judging from the Medicare cost growth-reduction provisions in the health care reform bill.

*By James Kwak*

## Another Path to Cap-and-Trade

James Kwak | 14 Jan 2010

There's been a lot of talk about California's budget crisis and its dysfunctional political system—a wound that was entirely self-inflicted by the anti-tax brigade, which made it possible for one-third of one house of the legislature to block any increase in taxes. (See [Ezra Klein](#) for more.) But there's another area where California is putting Washington to shame: climate change.

The Economic and Allocation Advisory Committee to the California Air Resources Board recently released its [recommendations](#) for how emission permits under the state's cap-and-trade system should be allocated ([summary here](#)). The basic principles are that most of the allocations should be auctioned off, and about three-quarters of the proceeds should be given back to households in the form of tax cuts or dividend checks, allowing families to cope with any increases in energy prices that result from emissions caps. This, of course, is a far cry from Waxman-Markey, which starts off by giving most allocations to polluting industries, but is closer to the bill introduced by [Maria Cantwell](#) and [Susan Collins](#) in the Senate.

The difference seems to be that in California, the [Global Warming Solutions Act of 2006](#) mandated the creation of a cap-and-trade system (to get California to 1990 emissions levels by 2020) and handed the implementation details to the California Air Resources Board, which commissioned a panel of economists, public policy people, and businessmen to work out the details. (The Board is not bound to accept their recommendation, however.) So this is a contrast between letting regulators set rules and having Congressmen set rules. (In our current Congress, the latter gives coal-state Democrats an effective veto, since the Republicans will not provide significant votes to any Obama administration proposal.) In other contexts I've argued that regulators should not have too much discretion, but here it may turn out to be a better approach.

*By James Kwak*

## Design or Incompetence?

James Kwak | 15 Jan 2010

Or both?

In late summer or early fall, Citibank was running a promotion: if you opened a new account or moved a certain amount of money to your bank account, you would get a \$200 bonus within three months. Someone I know took advantage of this promotion, but as of Monday he still hadn't gotten the \$200 bonus, so he visited a branch.

"I was given the ridiculous explanation that I didn't surrender the promotion letter and that the promotion code NP55 was not linked (?) in the application. I told them that: (1) the letter is not a coupon to be surrendered, (2) I should not have to tell the customer service rep how to process the promotion, (3) there was no requirement that the letter even be presented (just go to a financial center, it states), and (4) the code only needed to be mentioned if applying by phone. They called me back in the afternoon and asked me to come back this morning. They first offered me some 'thank you' points, but I stood my ground. After calling several places they finally reached a Texas office that would further research my problem."

Eventually, he got a letter saying that Citibank would give him the \$200 credit.

I've often wondered about situations like this: Is this just garden-variety incompetence, where the marketing folks think of a promotion and the computer guys program the systems wrong? Or is it a sinister design, in which the company decides to pull a bait-and-switch, and will only make you whole if you complain? (This goes far beyond banking. Think about any situation where you were overbilled, and after spending hours complaining you only ended up where you should have been in the first place. I've always thought there should be a treble-damages rule or something like it for overbilling, because otherwise companies have an incentive to overbill everyone all the time, especially if they are near-monopolists like the cable company.)

I've generally leaned toward incompetence, because I think if a company actually did have such a sinister plan, it would leak (because

lots of people would have to know about it). But maybe it's something in between.

Paul Kiel of ProPublica has uncovered multiple cases where homeowners are not getting their trial loan modifications made permanent. That's not news. What is news is that the reasons the banks are giving for not making the modifications permanent are *complete bogus!* One person had his modification rejected by JPMorgan Chase because he made a statement that he expects his income to eventually recover; another was required by Wells Fargo to update his documentation during the trial period and then put into a second trial period because his income went up by \$80 per month. (If you're wondering why this matters, the big reason is that this way a bank can string you along making you think you'll get a modification before finally rejecting you; if they rejected you up front, you could have walked away and saved yourself the payments in the interim.) In both of these cases, this violated Treasury Department guidelines for the loan modification program.

Here's the thing. Jamie Dimon and John Stumpf are not reviewing documents and rejecting people's modifications. These decisions are being made by first- and second-line servicing center employees, who are following instructions they got from . . . somewhere. What's more remarkable, official spokespeople for both banks are cheerily giving bogus reasons for failing to make modifications permanent, unaware (until busted by ProPublica) that they are violating the Treasury Department's rules!

So someone is taking the trouble to create inaccurate instructions for the servicing centers and give inaccurate talking points to the PR department. It could be pure incompetence, I guess. But it could be something in between—ineptitude through conscious inattention. The bank's senior executives make the decision to participate in the loan modification program, but then they don't try very hard to make sure they are following the rules. They know that if they have a messed-up process, they can save on internal costs, and they can also drag out the trial modification periods, which means (a) more payments they wouldn't have gotten if they rejected people on schedule and (b) longer before they have to write down the loans in question on their balance sheet. So they aren't consciously giving orders to break Treasury's rules, they're just not trying hard to follow the rules, staff their servicing centers properly, train their people sufficiently, and test their computer systems thoroughly. And that way there's never a smoking gun; instead,

they can just say their servicing centers are swamped and they're having trouble implementing new processes fast enough. (Wait! That's what they've been saying about this very program for months!)

There doesn't even need to be intent here (although there could be). Companies focus on the things they think are important. During the financial crisis, all the banks were focusing on their cash levels every day, and I'm sure they did a very good job at it. They don't focus on things they think aren't important. It seems like JPMorgan Chase and Wells Fargo are not focusing on their loan modification programs, and Citibank is not focusing on delivering on its promotions, just on using those promotions to suck cheap deposits onto their balance sheet. If that ends up helping their bottom line, then so much the better for them.

*By James Kwak*

## Entrepreneurs and Risk

James Kwak | 15 Jan 2010

I planned to write about Malcolm Gladwell in [this post](#) a couple of days ago, but I had rambled on long enough, so I deferred it until later. Well, [Felix Salmon](#) beat me to the punch, which is all for the best anyway, since the connection was going to be John Paulson, and Felix knows much more about hedge funds than I do.

The topic is Gladwell's still-subscription-only article, "The Sure Thing: How Entrepreneurs Really Succeed," in which Paulson plays a starring role. The sub-sub-head in the table of contents says, "The myth of the daredevil entrepreneur," so even though I expected Gladwell to be annoyingly contrarian again, for once I expected to agree with him. The conventional wisdom, in this case, is that successful entrepreneurs get that way by taking big risks.

I'm inclined against the conventional wisdom because I co-founded a company, it's done pretty well, and I'm about the most risk-averse person I know. (Want proof? I even worked at *McKinsey*, the world's epicenter of risk aversion; two of the other founders were also former management consultants.) In my opinion, based on limited experience, to start a successful company you need to have a solid plan, a realistic assessment of your chances, the willingness to take on a modest amount of financial risk (starting a company is rarely the best way to maximize your expected aggregate income, and never the best way after adjusting for risk), and the belief that the non-monetary satisfaction you get along the way will more than compensate for the financial disadvantages.

Gladwell, however, wants to say something much more provocative, and in the process says something much more confused. To begin with, as Salmon points out, his definition of "successful entrepreneur" is unusual-looking at his examples, it seems to mean "anyone who makes a large amount of money as head of any kind of company, even if he made the money in the act of acquiring that company at a lowball price." (The implied definition of "entrepreneur" is "anyone who heads any kind of company," which includes, say, Chuck Prince. While Prince may be a failed CEO, calling him a failed entrepreneur seems silly.) Although hedge fund managers do technically head their own companies, they fit with almost no one's conventional definition of an entrepreneur; they are investing other people's money, and they don't create anything except new trades.

Much of the conceptual substance of Gladwell's article comes from "From Predators to Icons," a study by Michel Villette and Catherine Vuillermot (which I haven't read and won't read, so I'm counting on Gladwell's summary).\* According to them (this is a direct quote), "The businessman looks for partners to a transaction who do not have the same definition as he of the value of the goods exchanged, that is, who undervalue what they sell to him or overvalue what they sell to him or overvalue what they buy from him in comparison to his own evaluation." Gladwell adds, "He repeats the good deal over and over again . . . his focus throughout that sequence is on hedging his bets and minimizing his chances of failure." This is certainly a smart thing to do, and a good way to make money if you can do it, but it's an awfully narrow definition of what it means to be an entrepreneur; it's a better definition of a successful investor—Warren Buffett, for example. But how does it apply to, say, the founders of Apple, Google, Amazon, or Microsoft? In the case of Google, for example, everyone knew Internet search would be big; Page and Brin simply built a better mousetrap.

Also note that Gladwell's added sentence is a poor description of John Paulson's behavior: "But if he was genuinely going to make a trade of the lifetime, he needed more. Like a cocksure Las Vegas card-counter, he was eager to split his winning blackjack hand, again and again." [Greg Zuckerman, *The Greatest Trade Ever*, p. 177 in free pre-publication version.] And his short position got to the point where it simply could not be hedged. "Now that the ABX had tumbled from 100 to 60, Paulson had a lot more to lose—the index easily could snap back to 100. If the mortgage investments recovered in price, Paulson would be known as the investor who let the trade of the year slip through his fingers." His colleague Paolo Pellegrini tried to get Paulson to lock in more of his winnings, but he refused [p. 198]. And how can a real entrepreneur—Page and Brin, Gates and Allen, etc.—possibly hedge his position? When you have years of your life's work tied up in one project, it can't be hedged. You only have one life.

Gladwell wants to use his theory of "entrepreneurialism" and "risk-taking" to take a shot at stock-based compensation for corporate executives, arguing that we actually don't want CEOs taking risks. But the point of stock-based compensation isn't to encourage risk; it's to align the interests of CEOs and shareholders, because otherwise CEOs have the incentive to sit on their cushy jobs and cushy salaries and avoid mistakes that will get them fired. I don't think the problem with CEO compensation is stock *per se*. It's stock *options*, which give CEOs

asymmetrical payoffs; in particular, it's stock options that get reset when things go badly,\*\* so CEOs make money no matter what happens; and it's stock-based compensation that can be cashed in too early (as opposed to, say, three years after the CEO retires), creating short-term incentives to pump up the stock price.

The best encouragements to productive risk-taking are measures that limit the cost of failure for people who are actually creating something new, and this is one reason why Silicon Valley has been so successful. The financial risks of starting a company aren't that big, for most people. High-tech companies are typically started by people who could pull in low-six-figure salaries working for other companies, so they're giving up a couple of hundred thousand dollars in opportunity cost; the rest is typically angel investor or venture capital money. More importantly, there is (historically, at least), little stigma attached to failure, so there's little reputational downside to a failed startup. In a world full of risk-averse people, that's very important.

Anyway, Gladwell is right about the myth of the daredevil entrepreneur, but this is the wrong article to prove the point.

\* According to Gladwell, the study is based on case histories of successful entrepreneurs, which sounds an awful lot like selecting on the dependent variable. Again, I haven't read it, so he may well be wrong—but if that's what Gladwell *thinks* the study is based on, he should have steered clear.

\*\* Typically by exchanging old options at a high strike price for new options at a low strike price.

*By James Kwak*

## Too Big to Regulate?

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

At present, the debate among economists over whether our financial regulations should protect institutions on the basis that they are “too big to fail” (TBTF) still rages. Like many other economists, I distrust the reasoning behind the TBTF justification and rue the fact that the measures taken to prop up the U.S. financial system have made the largest banks even larger, while small banks are failing at record levels. In [my first guest post](#) I argued patchwork attempts to strengthen financial regulation without a “clean sheet” review were likely to be inadequate.

In this second post I look past short term bailouts and address the broader issue of establishing regulation of TBTF firms. Policymakers are faced with challenge of establishing a large regulator that retains the specialized expertise needed to manage complex markets – specialization more often found in a network of smaller agencies. To do so they will need to address the size and complexity of the financial sector itself. As before, I turn to examples from the utility industry, specifically the establishment and repeal of the Public Utility Holding Company Act of 1935 (PUHCA), that provide lessons for crafting regulation of complex industries.

There should be no question that any firm considered too big to fail must be regulated thoroughly and effectively. This is unquestionably the \$64 trillion question. We cannot give an explicit or implicit government guarantee to rescue a private firm without whatever control is necessary to prevent moral hazard. But what if the need to impose appropriate regulation itself becomes a limit on the allowable size or complexity of firms? In short, can a firm be too big to regulate?

In any such discussion it is important first to distinguish between several dimensions of big. The first dimension is the multiplicity of products and markets in which a company is involved. In context, this means companies that operate in commercial and investment banking, trading, insurance, and dozens of other product lines that are all “financial,” but which have different attributes, externalities, and regulatory requirements. Call this “firm complexity”.

“Organizational complexity”, the second dimension, tends to follow firm complexity, but it isn’t the same. This dimension has to do with the number and diversity of *business structures* owned by a single parent company. The larger and more varied the number of corporate entities owned or controlled by a single parent, the more layers of vertical ownership; and the more complex the cross-ownership claims, the more complicated the structure.

The third and final dimension is “structural bigness”. This is about having a large market share in a well-defined product and geographic market. This is the traditional meaning of big in the industrial organization field of economics. It is bigness within a market, or market dominance.

For most financial (as well as non-financial) products, structural bigness is policed by competition (antitrust) laws. (The insurance industry has enjoyed an antitrust exemption that Congress is now reconsidering.) Because I assume these laws will continue to be enforced, I assume structural bigness is not a factor in making a firm too big to regulate.

For the other two dimensions of bigness, product and organizational complexity, it’s a different story. In a nutshell, when the range of one firm’s market and organizational activities grows too large, it often becomes politically or administratively impossible to do a good job regulating it, whatever the particular tools and processes regulators use.

Firm complexity challenges regulation because it requires regulatory agencies with enormous resources to understand the linkages between extremely different financial product markets. To regulate a firm engaged in insurance, banking, investment banking, trading, and other products, a single regulatory agency will have to possess an unbelievably broad range of skills, tools, and resources. This is not to deny that there is a careful balance to be struck between too much and too little regulatory overlap, acknowledging sometimes conflicting problems such as regulatory capture and forum shopping.

It is politically unimaginable that the U.S. would ever establish a single financial sector super-regulator (an outcome far beyond the Fed getting the job of policing systematic risk). However, if we will rely on multiple specialized agencies to police one market at a time, then we have the current patchwork quilt that never allows narrowly specialized regulators to see the linkages between markets. It also encourages firms to create products that fall in the cracks between agency jurisdictions and

that no agency understands well enough to monitor. Placing limits on the number of markets a firm can operate in may reduce synergies and scale economies, but there should be no argument that it makes regulation far more likely to succeed.

For purely practical reasons, organizational complexity also makes regulation ineffective. As businesses get successively more complex and varied business structures, the ability of regulatory agencies to understand the company's financial position simply fades away. It is well-documented, for example, that Enron built a financial structure so complex that regulators could never understand what it was up to, even following its downfall. To cite one example, when the investigative staff of the U.S. Federal Energy Regulatory Commission (FERC) was directed to look into Enron's electricity trading practices, here's what they had to contend with:

The complexity of the issues confronting Staff and the agencies cooperating with the Commission is such that more time would be required to fully understand Enron's and other market participants' activities in the energy markets. For example, we spent a considerable amount of time analyzing Enron's massive information technology (IT) systems that were used to harness information and use such information for Enron's advantage. In short, the IT systems were functionally equivalent to the IT systems of a national trading exchange, *e.g.*, a stock exchange, coupled with the credit and risk systems of a large national bank, and linked to a large telecom company. The IT systems were designed to keep transactional data, such as a telecom IT system much do with telephone service customers such as customer service, billing, scheduling, and provisioning, but also link it to a sophisticated, on-line trading platform, and calculate the credit and risk exposure of each transaction. Because Enron traded 1700 different products on-line around the world, the trading had to be linked together in a secure manner.

Although Staff has focused its energies on relevant data, the size of the task is enormous. For example, as described herein, Staff is now reviewing approximately 1.8 terabytes (TB) of data, which is equivalent to the amount of data produced by a large telecom company. In addition, because the data had to be easily accessible to Enron employees, we are also reviewing nearly 1,000 spreadsheets that were populated with data from the IT systems. The spreadsheets were approximately 40 megabytes (MB) each and dozens were created daily.[i]

Fortunately for the FERC, its objectives in the investigations were confined to Enron's role in the Western power crisis of 2000-2001. No full accounting of Enron's actions was sought, and none has yet been produced.

The question of the size and institutional division of the analytic resources needed to properly regulate financial markets was the subject of my prior guest post. In this area, it is interesting that a National Institute of Finance has been proposed to create an independent body of expertise usable by regulators. Other regulated industries have this, such as the National Regulatory Research Institute, the Institute of Public Utilities at Michigan State University (MSU), and the Regulatory Assistance Project for energy regulators.

## Structural Limits in the Utility Industry

The energy utility industry has struggled to find the right balance between enabling effective regulation and allowing market and organizational complexity. Starting in the late 1880s, municipalities and small industrial firms began installing electric systems that were seldom larger than a handful of plants and lines. In the first part of the 20<sup>th</sup> century, industrial titans like J.P. Morgan and Samuel Insull did what we would now call a roll-up: they purchased dozens of small systems and assembled them into massive holding companies.

Although most of the local subsidiaries of these utilities had rates set by state or local regulators, these agencies could not understand or control enormous multistate holding companies. With massive, complicated holding companies, regulators could not determine the true cost of serving customers and therefore could not determine the true cost of serving customers and therefore could not set good cost-based rates. Complexity gave holding companies the tools to overleverage their companies, mislead investors and regulators, overcharge regulated, captive customers and subsidize unregulated lines of business.

Following the '29 crash, Congress asked the U.S. Federal Trade Commission (FTC) to investigate the financial practices of utility holding companies. The 101-volume FTC report found 19 categories of financial misdeeds, including:

... the issuance of securities to the public that were based on unsound asset values or on paper profits from intercompany transactions; the extension of holding company ownership to disparate, nonintegrated operating utilities throughout the country without regard to economic

efficiency or coordination of management; the mismanagement and exploitation of operating subsidiaries of holding companies through excessive service charges, excessive common stock dividends, upstream loads and an excessive proportion of senior securities; and the use of the holding company to evade state regulation.[ii]

In what one historian called “the most bitter legislative battle of Roosevelt’s first term,” Congress passed the Public Utility Holding Company Act of 1935, known as PUHCA. PUHCA essentially banned complex financial holding company structures for utilities, gave the new Securities and Exchange Commission (SEC) authority to approve utility mergers and security issuances, and made it extremely hard for utilities to buy or engage in non-utility lines of business. Drawing on the notion that utilities had large scale efficiencies, but only if systems were physically connected, it also required that all mergers between utilities created integrated systems.

These strong restrictions were based on a consensus that it was simply not realistic to try and regulate the rates and securities of extremely complicated holding company structures. It was “the very heart of the title,” said the Senate Report accompanying PUHCA, to “simply...provide a mechanism to create conditions under which effective Federal and State regulation will be possible.”[iii] Over the next 11 years, under federal supervision, the large holding companies were slowly divided and sold.

Although it is likely that the utility industry lost some efficiencies from the bright-line prohibitions introduced by PUHCA, there is little question that increases in efficiency continued. Over the fifty years following the passage of the Act, the industry grew by a factor of 100, the average power plant grew more efficient by a factor of five, and pollutant emissions (other than CO2) declined by a factor of 10,000. Real electricity rates dropped nearly continuously throughout the period. And if the industry was missing scale economies, this was surely more the case in the third of the industry that was publicly owned or a cooperative, where are still nearly 3,000 separate systems, as opposed to only about 140 investor-owned firms.

Many a utility CEO loathed the shackles PUHCA put in place. Utilities with interstate operations could rarely get permission to diversify into non-utility businesses, thus hampering shareholder growth. Utilities that did not cross state lines were exempt from PUHCA, and these intrastate

firms often dabbled in insurance, real estate development, fuel production, and other non-utility lines of business.

From this experience, we have something of a laboratory comparing utilities allowed to diversify and utilities that were not. I think it is a fair to say that the utility economics literature has not found large gains in new product synergies where PUHCA was not binding. Utilities inside a single state went through a wave of diversification in the 1970s, were largely unsuccessful, and have since primarily abandoned non-utility businesses. It could not have been costless, but PUHCA appeared to have its intended effect, making regulation relatively simple, practical and effective until the late 1970s.

## **PUHCA Repeal**

As deregulation of utilities (along with financial markets) gained currency in the 1980s, the industry pushed to repeal what it felt was an aging and unnecessary statute. The arguments for repeal were good. Financial regulation was far more comprehensive and seasoned by the 1990s than it was in 1935, with almost no one seeing the decay in its effectiveness now so apparent. Federal and state utility regulation was also now far more accomplished. Most of all, the requirement for physical integration made no sense in an industry that was intentionally de-integrating in order to introduce competition in parts of the sector. The economic structure of the industry was at odds with the Act.

PUHCA was repealed in the 1992 energy bill, but many of its provisions, meant to protect against excessively complex utilities, were essentially transferred to the FERC and state regulators from the SEC. Federal and state regulators were guaranteed access to utility holding companies' books and records, and the FERC cannot allow a merger that impairs the effectiveness of state regulation. Many state regulators discourage their regulated utilities from engaging in non-utility lines of business, and nearly all of them require a separation between non-utility and utility assets so that losses in unregulated lines of business don't affect the financial viability or rates of the regulated part of the firm. For a recent example, see this press release regarding the recent EDF-Constellation deal.

Technically, the removal of the physical integration requirement and other industry changes have enabled mergers and acquisitions. Between 1993 and 2007<sup>[iv]</sup> there was a wave of utility mergers, with 84 U.S. to U.S. combinations completed and a handful of acquisition of U.S. utilities

by foreign companies. Warren Buffet's holding company has purchased one utility, the Texas Pacific private equity firm recently purchased the former Texas Utilities Company, and several foreign utility holding companies now own state-regulated U.S. firms. Ownership of deregulated power generators is even more diverse.

Nonetheless, there are still strong limits on trades between utilities and non-regulated subsidiaries in a single holding company. State and federal regulators require that the regulated entity. And lately, the pace of utility mergers and acquisitions has slowed to a crawl. Many in the industry believe that this is because state regulators are starting to once again feel that utilities were becoming too big to regulate.

## Relevance to Financial Regulation

Regulation of the financial sector is a vastly more complex problem than regulating electric or gas utilities. There are dozens of products deeply interconnected in several different ways in a geographically global system. It is clear this complex, interconnected system needs far better regulation than it has today.

Many of the financial regulatory reforms under discussion involve limits on "bigness" as I have defined it. The Baseline Scenario has long been a strong voice for limiting bank size based roughly on overall systemic risk; more recently, the idea seems to have been embraced by Messrs. Volker, Greenspan, and Soros; (Two of my *Brattle Group* colleagues, George Oldfield and Michael Cragg, have also voiced this view. See "Life Boats for the Banks—Let the Holding Companies Swim," in *The Economists' Voice*). Still others call for no absolute size limits, but rather higher capital requirements the larger and riskier the institution. Chairman Bernanke, for example, calls for an approach that preserves "the economic benefit of multi-function, international [financial] firms."

Among these bigness policies, Mervyn King's (and others') proposal to separate commercial and investment banking (so-called utility and non-utility banks), comes closest to the policies that guide energy utility regulation today. Under King's proposal, commercial banks would be limited in the amount of risk they could take on and would receive protection against failure, while investment banks would have fewer constraints on risk but would receive no survival guarantee

While this is analogous to energy utility regulation, and may be a good idea for financial regulatory reform, it cannot be a complete solution. Even with good separation of "boring" and "non-boring" banks,

(somewhat different) regulation will be necessary for both types of firms, and close coordination will be necessary for all financial regulators. In addition to limits on “boring” banks, it may be necessary to limit, or at least oversee, the riskiness or size of “non-boring” financial entities, however they are defined. Vexing questions regarding the need for transparency, common clearing platforms, and position limits, in all financial product markets, remain. (See these comments from [David Brooks](#), [Sophia Grene](#), [Brooke Masters](#), and [Gillian Tett](#).

The interconnections between disparate financial products and markets and the need for overall prudential regulation creates an extremely complex tradeoff between multiple regulators who have the resources to specialize — and can serve as checks on each other — and the danger of missing the big picture or letting new markets and risks develop in the cracks between their jurisdictions. In this context, limits on firm size and complexity help by lowering the difficulty of assessing risks and policing activities within a single sprawling firm, in addition to reducing systematic risk. One has to wonder at passages like this in the *Financial Times*:

Then there is the idea of obliging the biggest, most complex banks to draw up “living wills” — certificates that would lay out a blueprint for how a bank should be wound up in the event it should fail, perhaps forcing it to ring-fence certain operations, such as its retail and investment banking, in separate subsidiaries. Regulators are determined the chaos that followed the collapse of Lehman Brothers a year ago should not be repeated. It has yet to be decided what form a living will should take, but the very notion has many banks up in arms that they will have to spend months, even years, untangling the complex corporate structures they have evolved both to comply with local regulations and to maximize the tax efficiencies.[\[v\]](#)

If the banks that have complete self-knowledge and control will take years to simplify their own structures, how will regulators do it during a crisis?

In short, limits on the complexity and product offerings of commercial banks may well be an essential part of the solution, but it is nowhere near the *entire* solution.

*By Peter Fox-Penner*

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Notes

[i] See “Initial Report on Company-Specific Separate Proceedings and General Reevaluations; Published Natural Gas Price Data; and Enron Trading Strategies.” Docket No. PA02-2-000, Federal Energy Regulatory Commission, August 2002, p. 9.

[ii] “The Regulation of Public-Utilities Holding Companies.” Division of Investment Management, U.S. Securities and Exchange Commission, June 1995, p. 3.

[iii] *Ibid*, p. 9.

[iv] “EEI 2008 Financial Review,” The Edison Electric Foundation, 2008, p. 45.

[v] See Patrick Jenkins, “Banking on the Future,” *The Financial Times*, Future of Finance Section, October 19, 2009.

## Baseline Scenario Catches Up to Last Year's Technology

James Kwak | 17 Jan 2010

I finally bothered to figure out how to push new posts (well, links to new posts) into the status messages of our [Facebook page](#). This means that if you are or become a fan of that page, links to new posts will magically appear on your Facebook home page (which they keep redesigning—does anyone besides me find it annoying when Web 2.0 companies keep changing their user interfaces around and forcing you to figure out how they work every couple months?).

I'm doing it this way: Blog -> RSS -> [Twitterfeed](#) -> [Twitter](#) -> Selective Tweets Facebook application -> Facebook page. So if you follow the Twitter feed you won't miss anything that's on Facebook.

Alternatively, if you use Facebook and want to stay within Facebook, you can go to our Facebook page and click on the RSS/Blog tab to read full posts.

As for me, I stopped using Facebook many months ago.

*By James Kwak*

## The “Miracle” Still Goes On For Someone...

Simon Johnson | 18 Jan 2010

*This guest post is by Ivo Pezzuto, Professor at the Swiss Management Center University (SMCU) in Zurich, Switzerland, and an experienced observer of the global financial services industry.*

I share the analysis of most economists and observers that the following are among the main causes of the current global financial crisis:

- the U.S. Federal Reserve's low interest rate policy at the beginning of the last decade, the resulting credit euphoria of both lenders and borrowers;
- the more “relaxed” credit initiation and control policies and procedures of lenders;
- the “exotic” innovative features of some mortgage lending products;
- the overwhelmingly optimistic view of future house prices which prevailed in the market that has led to both the housing and the mortgage lending bubbles;
- the widespread use of badly controlled (OTC trading) innovative financial engineering tools (i.e., derivatives, securitizations, CDS, CDO, MBS, RMBS, CLO, etc.).
- Imbalances, exchange rates and interest rates differences between the US and other emerging economies and the resulting speculative trading and arbitrages.

As I reported on October 7th, 2008 in my SMCU working paper (ISSN 1662-761X), however, from a more thorough and in-depth analysis of how the U.S. subprime mortgage loans crisis has originated and evolved, it seems to me that this dramatic financial and economic event might not have been generated only by the above mentioned items.

My assumption is that many bankers probably knew quite well what was really happening to their subprime mortgages portfolios and why. These explanations are reported in my SMCU working paper which can be downloaded free-of-charge from [this link](#), or reading my chapter ([chapter 16](#)) in the forthcoming book of [Robert W. Kolb](#), Professor of Finance/Frank W. Considine Chair of Applied Ethics at the School of Business – Loyola University Chicago.

These days, unfortunately, we are still reading of the persistence of unethical or at least “questionable” behaviours of some key players in

the financial industry. Some of these organizations are rewarding their executives with higher salaries and bonuses, while 10% of the American workforce is unemployed thanks to “miraculous lending and financial engineering” practices.

I am not against in principle granting employees and executives generous bonuses if they are well deserved. I just hope that after such a dramatic crisis, there will be more rigorous attention to reward only those who have actually worked to improved general economic conditions and not only their personal wealth through financial speculation.

Furthermore, it seems as if some organizations are still relying on the “too-big-to-fail” philosophy and on the government’s protection to continue to grow aggressively their highly volatile derivatives and investment banking portfolios, or using the TARP funds (provided by the US taxpayers) and the Federal Reserve’s aggressive “monetary easing” policy (Fed Funds close to zero % or “money for free”) to increase their present and future salaries/bonuses through more profitable speculative operations.

The massive protections, recapitalizations, nationalizations, and financial and liquidity support banks received were orchestrated by governments and central banks to avoid systemic risks (long recession and potential depression) and the highly probable implosion of giant banks and other key financial institutions in the US and other markets. Now it is very sad to see that some of these funds have been misused by some bankers to continue to speculate in highly profitable and risky financial engineering operations instead of devoting their time, money, effort, and soul in helping troubled companies to avoid bankruptcy, the overall economy to grow, to reduce unemployment, to invest in R&D and innovation projects, to finance sustainability and green economy projects, and to restore trust and hope in the mind of troubled mortgage loans borrowers.

It is also sad seeing some bankers aggressively rejecting any introduction of additional and necessary regulation of the financial sector since they think that the bad times are over now. Regarding this last issue, I would like to stress the an important point. We all know that banking and financial markets are globalized today, thus the G20 countries have to be very careful not to introduce in the coming months or years significant discrepancies in their countries’ regulations of the financial sector – otherwise there will new opportunities for arbitrages

and speculations taking advantage of the different national policies and rules.

Overall, I think we still have a long way to go..... ..... but fortunately, I feel that President Obama is moving in the right direction.

*By Ivo Pezzuto*

# The Myth of Ariba

James Kwak | 18 Jan 2010

(Warning: long post ahead.)

I was minding my own business, reading *Past Due* by Peter Goodman (I got it from Simon, who I think got it for free), and there on page 43 I ran into Eric Bochner. I thought that name sounded familiar, and then I remembered what it was. Eric Bochner was a vice president of something or other (and then the vice president of something else or other) at Ariba, where I worked from April 2000 until September 2001 (I was also a consultant there from December 1999). Chapter 2 of Goodman's book is about the Internet bubble, Ariba is his case study, and Bochner is his source.

As far as I know, no one has made Ariba the poster child for the Internet bubble before—people usually go with WebVan, or Pets.com, or something similarly vaporous. Ariba is a more complicated story, but you can make a case that we deserve to be on the poster. At our peak we were bigger than all those pet food companies combined, with a market capitalization over \$40 billion (on quarterly *revenues* of about \$100 million at that time). More to the point, if Pets.com is comedy, Ariba is tragedy (well, not really, but you know what I mean): Ariba was a real company with a real product that got swept up in its own hype, with unfortunate consequences (but not fatal ones—Ariba today earns over \$300 million in annual revenues and a small profit).

Goodman wants to make the case that there was no there there, and Bochner says what he needs him to say. “It was never about creating a business, he said. ‘The whole idea was attract investment, sell your story to the Street, and then get yours out’” (p. 47). But there was a there there, at least at the beginning. Ariba’s founders—mainly experienced veterans of other successful technology companies, not twenty-somethings with no clue—had a great idea (automating procurement by large companies), and for the first few years almost everything went well. (Ariba was founded in 1996 by seven people; Bochner joined in October 1999, two months before I showed up as a consultant.) The product really worked, it was better than anything out there, the deals were huge, and most of the customers were happy. Goodman says, “there were obvious limitations to how much money Ariba could make selling its software. It was aiming its product at the big Fortune 500 companies. What happened when Ariba ran out of customers?” (pp. 44-45). But you can

build an enormous company selling only to Fortune 500 companies and their global equivalents (that's where the money is, after all), and even during the frothy days of the boom we sold almost exclusively to big companies (because that's where the money is).

In Goodman's account, Ariba was basically a fraud. In the book, Bochner was "the lead man in creating [the impression that Ariba was constructing a global marketplace]. . . . From the beginning, Bochner saw this as a rather impossible task," but he went through the motions anyway. Why? In Goodman's words, "the stock was the only thing that mattered. A valuable stock gave Ariba currency it could use to buy other companies" (p. 46).

As I recall, Ariba started out very much as a real company, but was actually blindsided by the Internet boom. (Update: Note that I only joined Ariba in 2000, so my knowledge of the early days is based on talking to many people who were there, not actually being there.) In 1999, as industry and financial analysts were talking up the business-to-business e-commerce boom, they were looking for the leaders. The problem was that since business-to-business e-commerce barely existed, there were no leaders. Ariba was the closest thing they could find, at that was already a stretch (at the time, Ariba's product did a good job of automating the process of creating a purchase order, but most purchase orders were automatically faxed to suppliers). Ariba had recently launched the Ariba Network, which was a hub where suppliers could publish electronic catalogs and buyers could route their purchase orders to suppliers, and the analysts hungrily anointed it the next big thing. There was nothing particularly wrong with the Ariba Network; it did what we told the customers it did, more or less. The problem was the hopes that were projected onto it by analysts and, increasingly, by Ariba itself. Ariba's stock price kept climbing and climbing, to the point where Ariba had to at least try to deliver on the market's expectations; otherwise, its stock would have collapsed and it would have been acquired. We got into a vicious cycle where the more the stock climbed, the more dependent we were on the story that was making it climb, and the more ambitious and aggressive we had to be.

We were by no means innocent victims. There was too much watching the stock price, and a lot of believing our own marketing. The jargon that Goodman makes fun of was terrible, and I was responsible for some of it. More important, no one put a gun to the CEO's head and said, "You must try to build a global network of electronic marketplaces and earn transaction fees by providing services to all the participants in that

marketplace.” The management team could have said, “This is silly. We’re going to ignore the hype and focus on what we do well, which is automating corporate procurement of indirect goods” (not direct manufacturing inputs). That’s what we should have done, even though it would have meant a collapse in the stock price and being acquired. But the problem is we were swept up in the hype like everyone else. It wasn’t just the analysts. The *customers* all wanted to be building global electronic marketplace, and in that group I include just about every large corporation in the world; they were all talking to us and to our competitors (Commerce One, Oracle, i2). They all wanted an e-commerce strategy (because without one their stock prices were being pounded) and *we were their e-commerce strategy*. The customers came to us and said, “We want this, everyone says you’re the best, therefore you’re our best hope. And here’s a big pile of money.” And we did our best to build what they wanted. The problem wasn’t that the software was impossible to build; we could have built it, although it would have taken a lot longer than anyone wanted to wait. The problem was, as Bochner says, the degree of industrial reorganization required was just not feasible in the short timeframe. It was a business model problem: there was no business model for, say, a single giant marketplace where small business bought everything they needed from a universe of suppliers, all hosted by Bank of America. Bank of America thought there was gold in that hill, and we sold them a semi full of shovels.

Back in early 2000, I think most of us thought it was possible. Otherwise, it’s hard to explain the energy, the motivation, and the immense amount of work most of us did. Goodman says on page 55, “The tech start-ups and their Wall Street handlers implicitly ridiculed the work ethic as an antiquated notion while speaking to a different lobe of the American brain—the part ruled by the frontier dream of finding a mountain of gold and never working again.” I beg to differ. Maybe the dream was to never work again, but most people realized that to get there you had to work very, very hard, and often at multiple startups. (There are certainly examples of people who used connections to parachute into startups just before they went public, but those people are generally hated within the startup world.) Goodman is right that the discount brokers like Ameritrade did create the illusion that you could become rich by sitting in your pajamas and trading stocks, but I don’t think the image of Silicon Valley ever included the idea of knocking off work at noon and hitting the golf course (except maybe for venture

capitalists). If Ariba really had been a fraud, then the only people working hard would have been in marketing, PR, and investor relations.

Over time, as with all bubbles, we began to doubt. By late 2000, I think most of us realized that reaching the expectations the market had for us was a long shot. And as I said, the fundamental problem wasn't the software, although the software wasn't as good as it could have been. It was that the customers were failing at building the marketplace communities as fast as they had envisioned, and as the bubble imploded suddenly they were no longer interested anymore, and suddenly the market expected us to collapse. As it turned out, the customers didn't really want what they had been desperately scrambling for less than a year before. And we had over two thousand people lined up to build shovels that no one wanted.

There are obviously parallels to the financial craze of 2004-2007, and we did more or less play the part of Chuck Prince (music, dance, etc.). All of the paper wealth went to the heads of people at the boom companies, who started thinking they were smarter and better-looking than they actually were, just like overpaid bankers are convinced they are actually smarter than their college friends who got Ph.D.s in physics and are now struggling junior professors. (Unlike the Wall Street bubble, however, most of that wealth stayed on paper, because of the rule that stock options vest over four years, and the tendency for most people *not* to cash out at the first opportunity.)

But the big difference, as many have noted, is that ours was an equity bubble, not (for the most part) a debt bubble. Technology startups were funded by venture capital firms, which generally have no debt, and by stock offerings; they generally don't have the assets and steady cash flows to borrow money. (The telecom infrastructure companies were an exception.) There was little margin borrowing to buy stocks, as compared to the 1920s, so when the NASDAQ crashed, the damage did not spill over into other asset classes, and the financial system didn't even wobble.

In Goodman's story, the tech bubble had a scarring effect on the American psyche—two of them, actually. On the one hand, it fueled the myth that you could get rich through investments (buying tech stocks), which shifted household behavior away from working and saving and toward living off of anticipated capital gains. On the other hand, he says the collapse of the tech bubble created a “paralyzing state of cynicism” (p. 81) that hurt the economy for years afterward. Well, which one is it? I

think the simplest explanation is that people invested in tech stocks because they wanted to get rich, and they got burned; the real estate bubble is considerably more complicated, because in many cases people *had* to overpay for housing, because people have to buy houses (or rent, but in many areas it's hard to find good rentals—that's a whole other story), whereas no one *had* to buy stock in WebVan.

For those ex-Aribians wondering what happened to Eric Bochner who don't want to buy the book, he's apparently now running a chocolate factory in Iowa City, and he implies that he didn't take much money off the table when he could ("The money I had then, I wish I had now" [p. 49]). I do know a few people who took everything off the table that they could, but only a very few. Most people lost their paper wealth along with everyone else's paper wealth (and unlike Dick Fuld, they hadn't sold hundreds of millions of dollars of stock on the way up).

*By James Kwak*

## So This Is What an Election Is Like

James Kwak | 18 Jan 2010

Martha Coakley just called me for, oh, the fifteenth time over the long weekend. I get multiple fliers in my mailbox every day. People from other states are calling me and asking me to volunteer. I'm sure I would be seeing nonstop ads on TV, except I don't watch TV. All this started within the last week when, as many news outlets have noted, the Democrats woke up and realized they might actually lose Ted Kennedy's Senate seat.

We're not used to competitive elections here in Massachusetts, certainly not competitive elections with national implications. But this one is huge. The Republicans have been admirably or distressingly able, depending on your perspective, to hold forty votes against more or less anything the Democrats and President Obama want to accomplish, including health care reform. I think it's a fairly easy bet that if Coakley loses, health care reform is dead until 2013 at the earliest, since there is no chance the Republicans will allow anything that looks like an accomplishment to occur if they can possibly help it. So if you live in Massachusetts, and you care about health care reform one way or the other, you should take the time to vote tomorrow.

**Update:** A friend emailed to point out that should Brown win, the House Democrats *could* pass the Senate bill, which presumably would not then have to go back to the Senate to be voted on again. (If the conference committee modifies the Senate bill, then it would have to go back.) Then some provisions could be modified through the budget reconciliation process, which only requires 51 votes. So a Coakley defeat might not be the end.

As for the comment about whether the Democrats could have negotiated with the Republicans to pick off one or two votes, they tried that for months—first via the Baucus Group of Six, then later directly with Snowe. Snowe ended up pulling out saying that the Democrats were rushing the bill, when they had spent several months talking to *her* specifically.

*By James Kwak*

## Wall Street Suing over Bank Tax?

James Kwak | 19 Jan 2010

Let's hope this gets laughed out of consideration. According to the New York Times, the Securities Industry and Financial Markets Association is considering a lawsuit on the grounds that "a tax so narrowly focused would penalize a specific group." The Times articles doesn't use the words, but I'm guessing they are thinking of claiming that it is a "bill of attainder"—an act of Congress that punishes specific people for alleged wrongdoing, without a judicial process—which is specifically prohibited by the Constitution.

But even leaving aside the fact that the Supreme Court has rarely overturned anything as a bill of attainder, there are not one, but two barriers in the way. The first is that the original TARP legislation mandated that the government had to recover the costs of TARP from the industry. The second is that the bank tax is really a (too small) tax on large banks that enjoy a too-big-to-fail subsidy from the government. And since the banks enjoy an implicit government guarantee, they should pay a fee for it (in this case, a mere fifteen basis points on uninsured liabilities), both to defray the costs of future bailouts and to (very partially) level the playing field relative to smaller banks without government guarantees. For political reasons, the administration is trying to dress the tax up as punishment for Wall Street, which begins to sound like a bill of attainder. But under the covers, it's simply sound regulatory policy (though, again, too small).

**Update:** Greg Mankiw thinks that "on the economic merits, there may be a case for the bank tax" as a means of offsetting the implicit government subsidy for TBTF banks. "It certainly won't be perfect. But it is possible that it will be better than doing nothing at all, watching the finance industry expand excessively, and waiting for the next financial crisis and taxpayer bailout."

*By James Kwak*

# A Trap Of Their Own Design

Simon Johnson | 19 Jan 2010

At this stage in the electoral cycle, Democrats should be running hard against big banks and their consequences. Some roots of our current economic difficulties lie in the Clinton 1990s, but the real origins can be traced to the financial deregulation at the heart of the Reagan Revolution – and all the underlying problems became much worse in eight years of George W. Bush's unique brand of excess and neglect.

The mismanagement of mammoth financial institutions over the past decade produced a crisis in September 2008 that required a substantial fiscal stimulus – among other bold government measures – simply to prevent the outbreak of a Second Great Depression. That sensible fiscal response, plus the “automatic stabilizers” that worsen any budget (and help limit job losses) as the economy slows, will end up adding around 40 percentage points to our net national debt as a percent of GDP. If you want to accuse the Obama administration of wantonly increasing the national debt – then let's talk about the circumstances that required this fiscal policy.

The theme for the November midterms should be: Which part of the 8 million jobs lost [since December 2007] do you not understand? The big banks must be reined in and forced to break themselves up, or we'll head directly for another such crisis.

Instead, the Democrats have fallen into a legislative and electoral trap that – amazingly – they built for themselves.

Top Democratic political strategists have become obsessed with the idea that they must pass legislation on financial reform, no matter how much that requires compromise (e.g., discarding the consumer protection desperately needed in this arena) – the thinking is that as they control the Presidency, House, and Senate (sort of), any other outcome will be judged a failure.

This is a mistake Teddy Roosevelt would not have made. The point is not to pass laws, irrespective of content; the point is to win on substance – by convincing the mainstream middle that you are right. When you're up against the most powerful people in our society – the kings of finance – there is little chance that a direct legislative assault will work; they give too much to campaigns across the political spectrum and their control over the official mindset is still too strong.

Instead, the administration needs to come at such opponents in a different fashion. Writing in today's Financial Times, Krishna Guha proposes innovative anti-trust action against big banks with oppressive share of particular markets; this would not require legislation.

Also in Tuesday's FT, Peter Boone and I suggest combining regulatory action (raising capital requirements steeply) and a size cap on our biggest banks – which could become the centerpiece of legislation that fails in the Senate this spring, after a great struggle, and then becomes a rallying cry for November. Bring the leading Senate Republicans out into the open and force them to articulate their views on "too big to fail"; you will be surprised (and perhaps disappointed, depending on where you are coming from) to hear their views – they are happy for our biggest banks to continue to operate substantially as they did during the Bush years.

Senator Shelby (ranking Republican on the Senate Banking Committee) shows no inclination to rein in our largest banks. He is cooperating with Senator Dodd at this point – presumably just in order to further weaken the likely financial reform legislation. The likelihood this will lead to meaningful reform is rapidly approaching zero.

Think of it this way. If the Democrats lose badly in November – as seems likely, with their current weak and unconvincing narrative about the financial crisis and origins of our mass unemployment – then President Obama's reelection campaign will be a long struggle to redefine the message, presumably towards finding something he has changed in a major way. In that context, strong attempted action against the power of big banks would appeal to the left, center, and even part of the right. Why wait for defeat in November before making this switch?

Run hard now, against the big banks. If they oppose the administration, this will make their power more blatant – and just strengthen the case for breaking them up. And if the biggest banks stay quiet, so much the better – go for even more sensible reform to constrain reckless risk-taking in the financial sector.

When you are running against opponents with bottomless resources, great hubris, and a profoundly anti-democratic bent, get them to speak early and often in as public a manner as possible. Dig up and publish everything there is to know about them. Review and forward the details of how JP Morgan was humbled over Northern Securities and how John D. Rockefeller was finally brought to account.

FDR's favorite president was Andrew Jackson. The White House might like to read up on why – Jackson confronted, ran against, and

ultimately defeated, the specter of concentrated financial power. President Obama needs to do the same.

*By Simon Johnson*

# The Unproven Tradeoff of Growth and Inequality

James Kwak | 19 Jan 2010

“How do you feel about paying such high taxes?”

“I think it is terrific. . . . I get a little bit angry because constantly in Denmark there’s this talk that we have to lower the taxes, lower the taxes, lower the taxes. And I can only say I’m very young, I am only 25 years old, and already the system has provided me with a great education and help whenever I need it. I have been able to go the library whenever I needed it. I have not been to the hospital many times in my life, but when I have been it has not been a problem. I mean, I think we are so privileged that it is so wrong to attack this system.”

That’s a Danish student on Planet Money’s [latest podcast](#), around the 14:40 mark. That seems perfectly sensible to me. If you are getting services that you value from your government, then you are going to be more likely to favor a system with high taxes. Obviously not very many Americans feel this way; since the Reagan Revolution if not the 1970s, there has been an increasingly widespread belief that government spending is wasteful, and therefore people want to hold onto their money. But there’s nothing irrational or bizarre about thinking that high taxes and high benefits are good, and you don’t have to agree with her to see that.

But this is what Adam Davidson of Planet Money had to say about it: “David [Kestenbaum, the reporter on that clip], it’s like you went to Bizarroland, where everything is the opposite.”

I like Planet Money. I think they do a good job of presenting economic issues in an accessible, informative form, and they line up some great people for interviews. So I think it’s telling that on an issue as basic as this—is small government necessary for economic growth—they have internalized the economic orthodoxy so completely that Denmark becomes “Bizarroland.”

And I’m not just picking on one word. To prove that I’m not taking him out of context, here’s a much longer version of Davidson’s position, from around the 10:30 mark:

“This tradeoff—which I think is probably essential—between equality and stability on the one hand and economic growth on

the other. More libertarian economists, more free market-oriented economists would argue, I think, that sure, if you have a real free market, there's going to be more inequality, people with more skill, people who put in more effort, are going to get more on the other end, there is going to be a bigger disparity, there's also going to be less stability, there are going to be booms and busts. But, over time, that free market economy is going to be so much richer, the pie is going to be so much bigger, that every slice is going to be bigger and bigger. . . . Quoting President Reagan, 'a rising tide lifts all boats.' And obviously, in Denmark, you have economists who say, 'well, wait a second, we're willing to trade,' and I'm sure there are many people in the United States who are willing to trade some degree of growth for stability and equality. Now I think over a short term almost anyone would trade growth, because each year growth is only 2 or 3 percent, and inequality and instability can be quite unsettling. I think what's interesting, as we've explored in our economic history sessions, is, over a long period, over decades and centuries, that growth starts adding up, and you start seeing the phenomenal, unbelievable rise in the standard of living that you see in industrialized nations, that you don't see in more centrally controlled economies. But of course, Denmark has benefited from that, so they really haven't had to pay as much of the cost as maybe some libertarian economists would have thought they would have."

I feel bad picking on Davidson, because (a) he does great work, (b) he's just speaking extemporaneously here, and (c) Planet Money did just put together two great episodes on Denmark, land of high taxes, low unemployment, and low income disparity. But my point is not that he's wrong; it's that mainstream, centrist, reasonable people have these beliefs internalized like this. This tradeoff between equality and growth is a theory of Davidson's "more libertarian economists," but by the end of the passage (from "Now I think"), he's assuming it's true, and that to get the increased prosperity of capitalism you have to have a high degree of inequality and instability. This is the kind of thing you ordinarily hear from bankers like Brian Griffiths or Bill George; that so many people take it for granted is the problem.

First, it's not obviously true that the more free your markets, the faster you grow. Denmark, for example, has a higher GDP per capita than the

United Kingdom (though lower than the United States). Maybe that's because of oil and natural gas, so I'll just say that you'd have to do some real analysis to prove that point. Also, as Kestenbaum pointed out in the podcast, the United States had extremely high top marginal tax rates during a period of very high growth after World War II. It would not shock me if you could find a regression showing that smaller government correlates with higher growth; but it would also not shock me if you could find a regression showing that greater income disparity correlates with lower growth.

Second, it stretches plausibility to argue that more free markets and smaller government always lead to more growth—that the optimum is all the way at one end of the graph. In completely free markets, you end up with monopolies, which give you monopoly pricing and less innovation. You get tons of negative externalities. You get entrenched aristocracies (because the aristocrats own the monopolies) and a rigid social structure, which is bad for growth. You need to be somewhere between the two poles of “free markets” and “central control.” I think you want to be much closer to the former than the latter. But Denmark isn't a centrally controlled economy. On that spectrum, it's a capitalist economy that happens to be just a little bit further from the free market pole than ours. (In the [previous podcast](#), they talked about how it is very easy for companies to fire people.) I don't see any a priori reason to think that our point on the spectrum gives you higher growth than theirs.

Now, because otherwise someone would bring it up, there is an economic argument for why free markets are better than paying high taxes and letting the government manage things. In one sentence, the argument is that resources are better allocated if they are allocated according to individual buying decisions, because those decisions reflect people's real preferences for different things. That argument is almost certainly right for many things, like toothpaste. It's better for companies to try to figure out what kind of toothpaste we want, and for us to vote by buying toothpaste, than for us to all pay a \$6 annual tax to the government and have it manufacture all of our toothpaste.

But the argument is almost certainly completely wrong (or its implications are normatively intolerable) for some other things, like national defense or police protection; could you really fund the military by asking people how much they are willing to pay for protection, and then *not* protect the people who didn't pay? And many people, including me, think it is wrong for many things that fall in between toothpaste and national defense.

We don't need to get into those specific debates here. But there's no a priori reason to believe that we in the United States have figured out the optimal size of government, where the government does everything it can do better than the private sector and vice-versa. (In fact, people on both sides of the argument would argue vociferously that we are not at that optimum.) It's possible that Denmark is at a *more efficient* point than we are. And so there's no a priori reason to assume that there is any tradeoff between the United States and Denmark. Maybe their system is just better than ours, across the board; maybe ours is just better than theirs, across the board (and maybe their positive results are due to other factors, like oil reserves, cultural homogeneity, and lower defense spending). If we had higher taxes, bigger government, and more redistribution, we *might* have slower economic growth. But we might not.

(PS: David, high domestic taxes may lead Denmark's best soccer players to play in other countries, but that doesn't affect their chances of winning the World Cup, because they remain Danish for soccer purposes even if they play in England or Spain. Almost all the top Brazilians, for example, play in Europe, but they still play for Brazil in international competitions. In fact, Denmark won the 1992 European Championship, although they did only sneak into the competition because Yugoslavia was excluded.)

**Update:** Marton points out that Danish players play in other countries not because of lower marginal tax rates, but because the clubs there have bigger fan bases and therefore can pay much higher gross salaries. In either case, they still play for the Danish national team—and the experience of playing in other countries with better leagues probably makes them better players.

*By James Kwak*

## Design or Incompetence, Part Two

James Kwak | 19 Jan 2010

Last week I wrote a [post](#) about how banks entice customers with promotions and then fail to keep up their end of the bargain, forcing customers to waste their time just getting the bank to do what it promised to do in the first place. As I wrote, then, the problem is by no means limited to the financial sector.

David Lazarus of the [Los Angeles Times](#) has a horror story about Aetna, the large health insurance company. The basic facts are:

1. Aetna increased a customer's monthly premium by \$32 as of August.
2. On September 30, Aetna sent her a letter saying her premium had gone up. (This is the letter supplied to the Los Angeles Times by *Aetna*, which I think is pretty clear proof there was no earlier letter.)
3. Beginning in October, the customer began paying the higher premium.
4. In November, Aetna rejected payment for a doctor's bill.
5. The customer contacted Aetna, who said she had missed payment for October—which wasn't true (she had paid the higher premium for October).
6. When the customer appealed, Aetna wouldn't let her simply pay the extra \$64 (the difference for August and September), and insisted on rescinding her policy.

The customer in question is a cancer survivor who needs regular medication and checkups—hence the kind of customer that health insurance companies [want to drop](#) if at all possible.

When the LA Times intervened, Aetna agreed to reinstate her policy.

But what's the penalty for Aetna? Zilch. What incentive does Aetna have to stop screwing its customers? None.

According to Alan Greenspan, the market can solve this problem: customers would leave Aetna because of its shoddy customer service. But most customers get their insurance through group plans and hence have little or no choice of their insurer, and the corporate HR departments for the most part select those plans based on price, since they are getting completely squeezed by rising health insurance premiums. There simply isn't very much competition in insurance plans, which are sold on the state level. And the customer in this case was on

COBRA, meaning she had absolutely no ability to switch (and would probably have had to pay a huge premium for insurance in the individual market because of her preexisting condition).

As far as I know, the health care reform bill wouldn't actually solve this specific problem, since the general problem of companies screwing up their billing processes and then blaming their errors on the customer goes far beyond health insurance. (I think the simple solution is that companies should have increased liability for their own errors—some large multiple of the amount in question.) With reform, though, at least the customer could have gotten a new plan at a reasonable price (because of the prohibition on medical underwriting).

Thanks to Ted K. for passing this on (via email, in this case).

*By James Kwak*

## Economic Commentary from 30 Rock

**James Kwak** | 20 Jan 2010

Who needs blogs? Just listen to Jack Donaghy (Alec Baldwin).

To Kenneth Parcell (Jack McBrayer), in Season 3, Episode 4:

“Next stop homeownership. [Pause] I’m just kidding. The middle class is dying. You’ll be renting forever.”

To Liz Lemon (Tina Fey), in Season 3, Episode 8:

“What do we elites do when we screw up? We pretend it never happened and give ourselves a giant bonus.”

(Yes, I am way, way, behind. My wife and I only watch TV shows on DVD or streaming [Netflix or Hulu], we watch very little TV at that, and for all of 2009 we were watching Battlestar Galactica [still two episodes left].)

*By James Kwak*

# How Supposed Free-Market Theorists Destroyed Free-Market Theory

James Kwak | 20 Jan 2010

*This guest post was contributed by Dan Geldon, a fellow at the Roosevelt Institute. He is a former counsel at the Congressional Oversight Panel and a graduate of Harvard Law School.*

Over the past year, there has been much discussion about how the financial crisis exposed weaknesses in free-market theory. What has attracted less discussion is the extent to which the high priests of free-market theory themselves destroyed meaningful contracts and other bedrocks of functioning markets and, in the process, created the conditions for the theory's weaknesses to emerge.

The story begins before Wall Street's capture of Washington in the 1980s and 1990s and the deregulatory push that began around the same time. In many ways, it started in 1944.

In that year, Frederich von Hayek published *The Road to Serfdom*, putting forward many of the ideas behind the pro-market, anti-regulatory economic view that swept through America and the rest of the world in the decades that followed. Von Hayek's basic argument was that freedom to contract and to conduct business without government meddling allowed for free choice, allocated resources efficiently, facilitated economic growth, and made us all a little richer. Milton Friedman built on Hayek, creating an ideology that resonated with conservatives and ultimately became the prevailing economic view in Washington.

While many have noted how information asymmetry, moral hazard, and agency costs reveal glaring holes in free-market theory and contributed to the current crisis, few have focused on the extent to which the supposed heirs to von Hayek and Friedman directly and purposefully created market distortions and, in the process, destroyed the assumptions of free-market theory.

In other words, the same interests that claim the mantle of von Hayek and Friedman pulled the threads from the free-market system and exposed the theory's greatest weaknesses.

In the years leading up to the crisis, the proliferation of fine print, complex products, and hidden costs and dangers – and the push against government regulations over them – exemplified the larger pattern.

While touting complexity as a form of innovation and railing against every attempt at government interference, supposedly pro-market forces used that complexity to clog the gears of free market machinery and to reduce competition and maximize profit.

When consumer credit contracts are buried in so much legalese that even experts can't understand all the terms – I heard one former CEO of a top financial company admit privately that his lawyers couldn't explain various mortgage terms and conditions — how can anyone believe the mortgage contract represents meaningful free choice? What consumer is able to weigh the benefits and costs of individual financial product features buried in the fine print and decide what to take and what to leave?

The corporate assault on comprehensible contracts is important because contract law has been the bedrock of capitalism for a long as there has been capitalism. By enabling free choice, meaningful contracts maximize economic efficiency. The assumption behind von Hayek and other theorists is that robust contract law facilitates a vibrant economic system and minimizes the need for government intervention in the economy. But that went out the window when von Hayek's theory itself was used to manipulate contracts. Now that products and fine print have become so perverted and incomprehensible, how can anyone expect contracts to steer the market in economically efficient ways?

We now know that the problem of complex contracts did not just harm consumers. Municipalities across the country were lured into buying toxic derivatives and institutional investors were routinely abused at the hands of complex products. Stories about Wall Street's math wizards purposefully cramming dangerous and confusing products down the throats of the unsuspecting are commonplace and legendary.

The world has changed in fundamental ways thanks to computers and complexity can have value, but the world as we now know it has made traditional economic assumptions that assume real choice and real contracts irrelevant. All that's left is the hollow façade of choice when your broker shows you where to sign or when you click "accept" after quickly scrolling through incoherent legalese. And we all are forced to accept this even though we know that the large majority of these products – and the actual deals around them — just aren't that complicated. The only thing that's complicated are the fine print and the economically valueless tricks and traps hidden in the legalese.

Some conservatives are quick to blame the fine print on litigation and trial lawyers. But that just doesn't explain all the complexity that has come to define Wall Street. Talk to a CEO of a major credit card issuer privately, and they will admit that "stealth pricing" was purposefully innovated to maximize profit by making contracts difficult to understand and compare. The proliferation of opacity and the lack of competition in the industry are not an accident.

The industry has not only manipulated contract language to prevent real agreement (or what contract lawyers call "meetings of the mind"), but it also massively increased its negotiating leverage with counterparties by making it so onerous to walk away from boilerplate and incomprehensible terms and conditions. It's not easy to negotiate with the other side of a 1-800 number, nor is it easy to go toe-to-toe with an industry that can and does get away with tricking and trapping even supposedly sophisticated investors.

And if you think all that were enough, many of the same conservative economists and lobbyists have fought tooth and nail behind the scenes to preserve implicit government guarantees created by the bailouts – guarantees that allow large banks to access capital more cheaply than the smaller banks left struggling to compete. While touting pro-market values and railing against "big government" attempts to break up the big banks, they are directly and purposefully allowing for market distortions. And those distortions help explain the massive consolidation we're seeing in the industry, the dwindling of real competition, and the proliferation of faceless conglomerates with infinite leverage over the drafting of terms and conditions.

What's really galling though isn't that supposed free-market advocates are so hell-bent on distorting the market wherever necessary to inflate profit. What's worse is the extent to which the same interests successfully advocated the rules that allowed this to happen under the well-worn guise of—you guessed it—freedom to contract and freedom to choose. That is, through their well-financed and well-oiled lobbyist teams, they facilitated the destruction of the freedom to contract and free choice while pretending to do the opposite. They killed the free market in the name of saving it.

The greatest lesson from the crisis that we haven't yet learned is that "industry interests" and "free-market interests" are not the same. In fact, they are more like oil and water, as the industry profits most in the absence of true market competition. And so it should be no surprise that

Wall Street has devoted itself to making contracts indecipherable, building boundless negotiating leverage and fighting for favorable breaks and regulation at every turn. What should be a surprise is that the same scoundrels that killed our markets (and also, mind you, wrecked the global economy and demanded taxpayer bailouts) have so ably sold themselves as natural heirs to von Hayek and Friedman — and that so many of us have let them.

*By Dan geldon*

## Commission to the Rescue!

James Kwak | 20 Jan 2010

It looks like President Obama is going to create the bipartisan commission to cut the deficit that Kent Conrad and Judd Gregg have been pitching—except that now Judd Gregg is against it.

According to the original Conrad-Gregg plan, the commission would have eighteen members—eight named by Congressional Democrats, eight by Congressional Republicans, and two by the administration, for a ten-eight split; if fourteen of the eighteen could agree on a deficit-reduction plan, Congress would have to vote it up or down without amendments. The Conrad-Gregg proposal is expected to be voted down in the Senate. So instead, Obama would appoint a commission by executive order, with six people named by Congressional Democrats, six named by Congressional Republicans, and six named by the administration, including at least two Republicans—for a ten-eight split; if fourteen of the eighteen could agree on a deficit-reduction plan, Congress would vote it up or down without amendments; however, Congress could separately choose to amend it. According to the Washington Post, Gregg “called a presidentially appointed panel ‘a fraud’ designed to do little more than give Democrats political cover.” Huh? I’m guessing Gregg’s objection is that Obama’s plan is based on an agreement with Congressional leaders, rather than actual legislation—but if you can’t pass the legislation, what else do you want Obama to do?\*

More, important, is this a good thing? My prediction is that it will amount to exactly nothing, although there is a possibility it could turn out badly. I simply don’t see how any plan can get the agreement of fourteen commission members—meaning all the Democrats and four of eight Republicans, or all the Republicans and six of ten Democrats, or something in between.

Some people like to point to the Social Security commission of the early 1980s, but Jackie Calmes’s article in the New York Times showed that that commission was a *failure*. We only got Social Security reform because (a) the administration negotiated with commission members after the commission itself broke down (remind me again, why was Alan Greenspan appointed Fed chair in the first place?) and (b) Congressional Democrats *added* a provision to increase the eligibility age. (b) is the rough equivalent of Congressional Republicans adding a tax increase today, meaning it ain’t gonna happen now.

Others point to the commission to close military bases. But that was a very different issue, because base closure was a district-by-district, state-by-state issue—not a Democrat-Republican issue like taxes and government spending.

So my prediction is that the administration, meaning Orszag's brainiacs, will put forward some sensible solutions that include tax increases and modest entitlement reductions; Congressional Democratic appointees will oppose the entitlement reductions but go along grudgingly because they want to accomplish something while Obama is in office; Congressional Republican appointees will oppose the tax increases and not go along; and we'll end up with gridlock. Even if by some miracle something comes out of the commission, if it contains a single dollar of tax increases (or even something that can be spun as a tax increase, like allowing any of the Bush tax cuts to expire on schedule), it will be rejected by Republicans in Congress, who will probably have more votes next year than they have now. As [Ezra Klein](#) said, "You can't govern this country if the party that doesn't control the White House simply refuses to give the party that does control the White House any accomplishments."

But there is a bad scenario, as [Mark Thoma](#) warns. The Obama administration could appoint six people who are willing to gut the safety net further in order to balance the budget, and it might be able to pressure Pelosi and Reid to appoint moderates instead of liberals. Then you might be able to come up with fourteen votes for a package that only includes entitlement cuts and no tax increases, which would be acceptable to Congressional Republicans and their veto-wielding minority.

Would the administration actually do this? I like to think they wouldn't, but at times they seem to care about balancing the budget more than *how* they balance the budget. I think it was pretty clear in the health care process that their one non-negotiable priority was fiscal balance over ten years. In other words, they want to save the country from future deficits so much that they might convince themselves it's better to accept whatever the Republicans give them than not do a deal at all. Which puts us in this curious situation where the party with the White House and the largest Senate majority in decades ends up letting the other party govern the country.

Although I expect the commission to be a dud (or worse), in the short term I think the politics are good for the administration and the

Democrats, because they can say they are doing something about the deficit—and it is actually something favored by deficit “hawks”\*\* like the Peterson Foundation. And maybe that explains why Judd Gregg is suddenly against his own idea.

\* And besides, I don’t see how Congress could prevent a future version of itself from amending the plan put forward by any commission. It could, conceptually speaking, simply retype the entire plan, add a few changes, and call it a new bill, couldn’t it?

\*\* Always put in quotation marks because most “hawks” supported the Bush tax cuts and the unfunded Medicare prescription benefit.

*By James Kwak*

## One More Thing . . .

James Kwak | 20 Jan 2010

. . . on that deficit commission. If I were Peter Orszag, I would be tearing my hair out. (Or maybe not, since he's happily engaged to be married later this year.)

It's obvious, and I've said it before, but I'll say it again. The big long-term national debt problem is all about health care. This chart is from the *January 2008 Budget and Economic Outlook* of the Congressional Budget Office—for those keeping score, that's one year before President Obama took office. It shows projected federal spending as a percentage of GDP.

The situation has gotten worse since then—overwhelmingly because of lost tax revenues due to the financial crisis and recession, not “big government” as some would have you believe—but the change over the last year is a rounding error compared to that huge light-blue wedge of Medicare and Medicaid. The health care bills now passed by both houses include, at the urging of Orszag and the administration, the most serious proposals ever put forward in Congress to curb the long-term growth of health care costs. In other words, no administration in the last few decades has tried as hard as this one to solve our nation's main long-term fiscal problem (although they bungled their management of the financial crisis and financial reform).

And what do they get for their efforts? Popular backlash against “big government” and “deficits” and Scott Brown in the Senate (although Martha Coakley had a lot to do with the latter). If politicians were actually serious about deficits, they would vote for health care reform 100-0 in the Senate. And pigs would fly.

By James Kwak

## Paul Volcker Prevails

Simon Johnson | 21 Jan 2010

Paul Volcker, legendary central banker turned radical reformer of our financial system, has won an important round. The WSJ is now reporting:

President Barack Obama on Thursday is expected to propose new limits on the size and risk taken by the country's biggest banks, marking the administration's latest assault on Wall Street in what could mark a return — at least in spirit — to some of the curbs on finance put in place during the Great Depression.

This is an important change of course that, while still far from complete, represents a major victory for Volcker — who has been pushing firmly for exactly this.

Thursday's announcement should be assessed on three issues.

1. Does the president provide a clear statement of why we need these new limits on banks? The administration's narrative on what caused the crisis of 2008-09 has been lame and completely unconvincing so far. The president must take it to the banks directly — tracing the origins of our "too big to fail" vulnerabilities to the excessive deregulation of banks following the Reagan Revolution and emphasizing how much worse these problems became during the Bush years.
2. Are the proposed limits on the total size (e.g., assets) of banks, or just on part of their operations — such as proprietary trading? The limits need to be on everything that banks do, if they are to be meaningful at all. This is not a moment for technocratic niceties; the banks must be reined in, simply and directly.
3. Is there a clear strategy for (a) taking concrete workable proposals directly to Congress, and (b) win, lose, or draw in the Senate, running hard with this issue to the midterm elections?

Push every Republican to take a public stand on this question, and you will be amazed at what you hear (if they stick to what they have been saying behind closed doors on Capitol Hill.)

The spin from the White House is that the president and his advisers have been discussing this move for months. The less time spent on such

nonsense tomorrow the better. The record speaks for itself, including public statements and private briefings as recently as last week – this is a major policy change and a good idea.

The major question now is – will the White House have the courage of its convictions and really fight the big banks on this issue? If the White House goes into this fight half-hearted or without really understanding (or explaining) the underlying problem of unfettered banks that are too big to fail, they will not win.

*By Simon Johnson*

# The White House Should Also Announce An Antitrust Investigation Into Major Banks

Simon Johnson | 21 Jan 2010

In the aftermath of Tuesday's Massachusetts special election debacle, the White House today is set to announce a major change of strategy on financial reform, with the president to propose new legislation that will limit the size and complexity of banks.

Such legislation is unlikely to pass the Senate. In fact, the approach to financial reform already in place, crafted by Senator Christopher J. Dodd with the blessing of the White House, was to trade away some parts of the House bill — including perhaps the potential new consumer protection agency for financial products — in return for sufficient Republican support to pass a bill in the next month or two.

But fresh from their success in the Democratic heartland, the Republicans will be less inclined than before to compromise in any meaningful way. They may keep negotiating, but the Senate Democratic choice will quickly become: pass a law with little sensible content, or don't pass anything and look ineffectual.

Fortunately, there is an alternative — one laid out neatly by Krishna Guha of the Financial Times on Tuesday. Instead of pursuing the issue of those “too big to fail” financial institutions exclusively through legislation, the administration could launch instead one or more serious antitrust investigations into the behavior of our biggest banks.

This is a sensible idea that is long overdue. There are definite elements of oligopoly in wholesale markets, underwriting new issues, and mergers and acquisitions both in the United States and around the world. This is part of the explanation for very high profits in banks — particularly big banks — over the past decade.

The question becomes: Is there evidence that our leading banks have used their pricing power or other aspects of their market muscle to keep out competition or otherwise distort behavior in very profitable arenas, like over-the-counter derivatives?

This is a complex question — and most of our existing antitrust experience and capability is more suited to the nonfinancial sector. But given the importance of finance in our economy — around 7 to 8 percent of gross domestic product — and the way in which concentrated credit markets have shown they can move the world economy, both up and

down, in destabilizing ways, we need one or more in-depth Justice Department investigations to determine exactly what big banks have been doing.

We may also need new theories of antitrust.

Most of our existing thinking was developed in response to the behavior of giants like Standard Oil — big industrial trusts at the start of the 20th century. There has obviously been some updating of the relevant conceptual frameworks to take account of “network economies,” most prominently around software, although we can debate how successful this has been.

But finance really is different. It reaches every corner of our economy. And the biggest banks have become even bigger: Assets in our largest six banks now stand around 60 percent of G.D.P., up from around 20 percent in the early 1990s. This degree of concentration has only increased during the crisis and bailout of the past two years.

It looks as if we are heading to a European-type situation, where individual banks can be as big as the entire economy. This is not a good destination. When a single bank becomes deeply troubled, like the Royal Bank of Scotland (which had assets that peaked at over twice the size of the entire British economy), that is a major fiscal issue for its home country.

In the United States, we urgently need regulatory action that would include raising capital requirements steeply, as well as a size cap on our biggest banks in order to rein them in. The administration’s existing proposals, including their latest bank tax, are ineffectual at best; today’s announcement is a major (and welcome) course correction – but by itself this is unlikely to be enough.

The administration and Congressional Democrats were planning to run for the November midterms on their health care achievements. That now seems high risk and low return.

Claiming to have averted a second Great Depression, even if true, is also not an obvious vote winner — after all, what exactly did this administration do that other administrations (led by John McCain or Hillary Rodham Clinton) would not have done? What “change” can you point to in any aspect of our financial system – other than for the worse?

Increasingly, Congressional Democrats are thinking about how to run against the big banks in November — these banks, after all, brought us a massive financial crisis, need to be reformed completely, and so far have

resisted any meaningful change. Launching a high-profile antitrust action would play well in that context.

*By Simon Johnson*

*This is an edited and updated version of a blog post that appeared on the NYT.com's Economix this morning. If you wish to reproduce the entire piece, please contact the New York Times.*

## Welcome, Barack

James Kwak | 21 Jan 2010

So Barack Obama has come around to the idea that big banks need to be made smaller and that smarter regulation (contingent capital, enhanced capital requirements for large banks, resolution authority, etc.) just won't cut it. Today he proposed limits on market share (measured by a bank's share of total bank liabilities in the United States) and a prohibition on internal hedge funds, private equity funds, and proprietary trading.

This is great. It means that the administration is moving in the right direction—breaking up big banks—and the president is putting his name behind it. For more on why these are good ideas, see [Mike Konczal](#).

OK, now for the caveats.

Any such legislation has little chance of passing in this session. The (now 41) Republicans had already signaled their intention to kill the Consumer Financial Protection Agency in the Senate, and I was already wondering how the CFPB could survive; banning proprietary trading will be that much harder to pass. (I could be wrong, since theoretically Republicans should want to eliminate implicit government subsidies and increase competition; it depends on how they balance that with their determination to prevent Obama from accomplishing anything.) And if I'm right about this session, I'm even more right about next session, since the Democrats are likely to lose seats in November for all sorts of structural reasons (first midterm election, more seats up for grabs, high unemployment, etc.). That said, this is a battle for the next decade. And having Obama on our side increases our chances of winning.

But is he actually on our side? The administration is trying to spin this as something it has been considering since last summer, believe it or not, not an abrupt shift in policy. Although Obama wants to call the prohibition of proprietary trading the "Volcker Rule," in late October Volcker ways saying quite clearly that the administration opposed him on this issue. This is an abrupt shift. And while I still welcome the shift, that makes me wonder how much of it is politically motivated. [Simon argued](#) earlier this week that the Democrats should run against Wall Street this November, and this could be what Obama is doing. Again, all good—the more visible the TBTF issue is, the more likely it is that we will solve this problem some day. But are Summers and Geithner on board,

or is this a political decision coming from Axelrod that will be discarded later?

Finally, there's the matter if the concentration limits will be strict enough and if they will be enforced. We already have a rule saying that no bank can have more than 10 percent of all deposits in the country, and that rule has been waived for three banks already. Simon and I favor strict limits and no regulatory wiggle room. There is talk, however, that the proposed size restrictions will leave the large banks as is and simply curb their future growth—which would mean, effectively, that they would have to *raise* the current 10 percent cap (since three banks are already over it), which can't possibly be right.

For today, though, I'll take it what I can get.

*By James Kwak*

## 13 Bankers

James Kwak | 21 Jan 2010

The day that President Obama came out in favor of size and scope limits for banks seems like a good day to tell you about our new book, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown*—in which we argue for hard size limits on banks, among other things. While we end up talking about the financial crisis, the way the government responded to it, and the too big to fail issue, it's really a book about power—the economic and political power of the banking industry both recently and throughout American history, the problems it creates, and what we can do about it.

The book will be out on April 6 (or maybe a week earlier), but you can already pre-order it wherever books are pre-ordered. In the meantime, to learn more, we have a new book web site with its own blog (for book-related news and thoughts).

Now, back to proof-reading . . .

By James Kwak

## As Is?

**Simon Johnson** | 21 Jan 2010

The White House background briefing is that their proposals would freeze biggest bank size “as is” — this makes no sense at all.

Twenty years of reckless expansion, a massive crisis, and the most generous bailout in human history are not a recipe for “right” sized banks. There is a lot of work the administration hasn’t done on the details — this is a classic policy scramble, in which ducks have not been lined up. But we should treat this as the public comment phase for potentially sensible principles — and an opportunity to propose workable details. The banks are already hard at work, pushing in the other direction.

It’s a big potential policy change, and my litmus test is simple – does it, at the end of the day, imply breaking Goldman Sachs up into 4 or 5 independent pieces?

*By Simon Johnson*

## Sheila Bair's Turn

James Kwak | 21 Jan 2010

Keith Epstein and David Heath of The Huffington Post have an [in-depth article](#) about how Sheila Bair got two mortgages on two different properties from Bank of America while she was discussing with them whether the bank could repay its TARP money to the government.

Let me start off by saying that I strongly, strongly doubt that Bair sought out a better deal on her mortgage because she is head of the FDIC or discussed her mortgage with any of the Bank of America bigwigs that she met with. That would be stupid, and it doesn't fit with anything I know about her. (Granted, I know very little about her.)

That said, WHAT WAS SHE THINKING? To begin with, Bair is on the record ([July 2009 congressional testimony](#)) opposing institutions that are too big to fail, saying "We need an end to too big to fail." She might argue that her solution is enhanced resolution authority, but she also said, "A strong case can be made for creating incentives that reduce the size and complexity of financial institutions." She has taken pains to differentiate herself publicly from Geithner, Bernanke, and other officials and regulators as a *critic* of big banks and of generous bailouts.

So how does she not understand that when you borrow money from Bank of America, it gets bigger?\*

In addition, how could she not realize that it looks terrible to be negotiating with Bank of America over its TARP repayment while she has a mortgage with them waiting to close?

Then of course there is the Watergate principle: the cover-up is worse than the initial wrongdoing. There are a few aspects to this cover-up.

Not surprisingly, the FDIC has a rule to cover exactly this type of situation. It reads: "No FDIC employee may participate in an examination, audit, visitation, review, or investigation, or any other particular matter involving an FDIC-insured institution, subsidiary or other person with whom the employee has an outstanding extension of credit." Bair should have simply gotten a waiver. Hank Paulson got a waiver to deal with Goldman Sachs on September 17, 2008, because he needed to save the financial system from collapse and Goldman was a crucial part of the system; Sheila Bair couldn't get a waiver before she took out a mortgage to buy a house and refinance her old one?

But here's the cover-up. Instead of admitting that they screwed up, the FDIC is claiming that she never needed the waiver in the first place. The FDIC's ethics officer says "We have discerned that she has not participated in a particular matter involving Bank of America at the time that she was negotiating a loan." This is a distortion of language (it was a matter, just not a "particular" matter) worthy of Bill Clinton ("It depends on what the meaning of 'is' is.") or George W. Bush ("The British Government has learned that Saddam Hussein recently sought significant quantities of uranium from Africa."). The FDIC is insisting that because Bair did not participate in an official FDIC action involving Bank of America, she wasn't violating any rule—even though she was meeting with senior Bank of America officials to discuss their relationship with the United States government.

But listen to this: "In response to a public records request, the FDIC redacted a reference to the meeting [with Greg Curl of Bank of America] from Bair's calendar, saying that matters involving examination, operating or condition reports on a bank are exempt by law from public disclosure." So which one is it? If it involved "examination, operating or condition reports on a bank" doesn't that mean it falls under the FDIC's ethics rule?

The other issue, which Epstein and Heath go into in depth, is that Bair got a loan on her old house that apparently she was not eligible to get according to bank policy, because she rents out part of it. I don't think this means there was a quid pro quo or Bair did anything wrong; I think the most likely explanation is that the loan officer thought "Wow, this is Sheila Bair, I'm not going to say 'no' to her," so she got special treatment without asking for it. But again, instead of admitting that Bair got a good deal, the FDIC said, "Our legal counsel does not believe [the mortgage] prohibits the rental arrangement in place and which was disclosed to Bank of America." Only when it was completely busted by the Huffington Post (which sent people into bank offices to try to get the same deal Bair got, unsuccessfully) did the general counsel switch the story to, "It may be a simple mistake by a local representative of Bank of America."

Does Sheila Bair not know what the rules are? Does she not think they apply to her? Does she not realize that basic common sense dictates that you don't engage in a new, large financial transaction with a bank that you are directly involved in regulating, without being extremely careful? Simon and I wrote a book trying to show people the close relationships

between the megabanks and the Washington political establishment. Bair is making our job that much easier.

\* When a bank makes a loan, it creates a new asset. It does *not* draw down another asset, unless it gives you the loan in cash. If it writes you a check or credits your bank account or credits someone else's bank account, it is creating a matching liability—not reducing assets by an equivalent amount.

*By James Kwak*

## Questions That Ben Bernanke Must Now Answer

Simon Johnson | 22 Jan 2010

*Update: the Senate needs to hold a new hearing for Ben Bernanke – here's the full proposal.*

Ben Bernanke's reconfirmation as chair of the Federal Reserve is in disarray. With President Obama having launched, on Thursday morning, a major new initiative to rein in the power of – and danger posed by – our leading banks, key Senators rightly begin to wonder: Where does Ben Bernanke stand on the central issue of the day?

There are three specific questions that Bernanke must answer, in some convincing detail, if he is to shore up his weakening cause in the Senate.

1. Does he support the President's proposed emphasis on limiting the scope and scale of big banks?
2. With regard to the key detail, is it his view that the size of big banks can be capped "as is" or – more reasonably – should we require these banks to contract or divest so as to return to the profile of system risk that prevailed say 15 or 20 years ago?
3. If Congress cannot act in the short-term, because of opposition from Republicans and some Democrats, does he see the Fed's role as taking the initiative in this arena – or will he wait passively for the legislature to act?

As running hard against the "too big to fail" banks is now a major theme of 2010 and beyond for the Democrats, how can any Democratic Senators feel comfortable voting for Ben Bernanke unless they know exactly what his position is on all of these points?

And given what we know about Bernanke's record and positions relative to these questions, absent new information it is not a surprise to see his support dwindling.

*By Simon Johnson*

## Secretary Geithner Needs To Get With The Program

Simon Johnson | 22 Jan 2010

The details of the new White House banking policy are somewhat vague and in places borderline incoherent – e.g., what exactly does “The President’s proposal will place broader limits on the excessive growth of the market share of liabilities at the largest financial firms...” mean (from point 2 in yesterday’s short and poorly edited statement)?

And the size restrictions currently in pencil on the back on an envelope near the president’s desk are almost certainly too lenient; the goal should not be a return to the status quo of 2007 or thereabouts - the clock must be rolled back much further and “too big to fail” completely removed from the financial map.

But the general principle behind our “Volcker Rule” is clear. Here’s what President Obama said, “Banks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers.”

Whatever you think of that notion or the exact wording, this clearly implies that banks will get smaller. Secretary Geithner apparently does not get this (transcript).

There are two possibilities given that Tim Geithner is a smart person with a great deal of relevant media experience – he did not misspeak.

1. Geithner is not on board with the policy shift. This would be understandable, as it directly repudiates what he has worked hard to achieve over the past year.
2. Geithner does agree with the obvious interpretation – provided by the president – of the Volcker Rule and associated principles. As an expert, he is certainly entitled to his own view, but this is beyond awkward.

President Obama said, quite plainly, “So if these folks [the big banks] want a fight, it’s a fight I’m ready to have”. He cannot fight this issue and these people effectively if his Treasury Secretary is not on board.

If the Democrats go at this fundamental shift in policy in a half-hearted manner or with mixed messages, they will be hammered so badly in November that the Massachusetts special election will feel like a victory in comparison.

Kindly ask Secretary Geithner to appear on all the weekend news shows with a convincing “clarification”.

*By Simon Johnson*

## Obama's First Year

James Kwak | 22 Jan 2010

It's late January and Scott Brown will be the next senator from Massachusetts, which means it's time for critical retrospectives on Obama's first year in office. I'm not going to try my own, but simply point you to two I found worthwhile. One, not surprisingly, is by [Ezra Klein](#), who says this is Obama's problem:

"Obama's presidency has tried to show, not tell. He's not given speeches about how government can work. He's not tried to change minds about the theoretical possibility of government working. He's tried to *make* government work. Winning achievements, not arguments, has been at the center of the administration's agenda."

Klein realizes the irony, of course; a president who is doing what we *say* we want presidents to do—govern—is being stonewalled by a right wing intent on winning the next elections, and sniped at by a left wing for compromising too much and for not scoring enough political points. But, as Klein says, whether the fault is Obama's, Congress's, or ours, it's not working.

The other retrospective is by [Nate Silver](#), who picks up on [David Leonhardt](#)'s insight that Obama's policies have been "politically partisan and substantively bipartisan"—that is, they are extremely centrist in content (center-right, some would even call health care reform, given how much it depends on private insurers), yet perceived as extremely partisan. In Silver's words, "what Obama has wound up with is an unpopular, liberal sheen on a relatively centrist agenda." His advice to the administration:

"The best case is when you can simultaneously achieve both a policy and a political victory. More often, especially given the structural constraints imposed by the Congress, you'll have to settle for one or the other. But I would be very careful about any course of action which concedes victory to Republicans on both levels. Mistakes were made along the way to health care reform, but you've paid the political price for health care: now pass the f—ing thing.

"As for the rest of the policies in your portfolio, take an inventory and figure out which have the votes to pass right now (through reconciliation where prudent), which can't be passed no matter what, and which could be achieved but will require some expenditure of political capital. And then on the other axis, wargame everything and figure which it would be to your benefit to have an extended public debate about (this would almost always be for political theater rather than policy reasons), which you should put up to vote, but as quickly as possible, and which ought not to see the light of day."

I think this week has shown at least that the administration has decided that real reform of Wall Street is something that they want an extended public debate about; I don't think they have the votes to pass it. Now they need Tim Geithner to stick with the team—although, in Geithner's partial defense, the proposal is pretty vague, and there are disturbing hints that the size component will only cap *future* growth rather than break up the current big banks.

Some of you know that I initially supported John Edwards in the Democratic primary because I thought he was a progressive dressed up in moderate's clothing. I didn't support Obama at first because of the opposite reason: I thought he was a moderate (all that talk about bridging divides and moving beyond partisanship) that many people thought was a progressive. (I don't blame Obama for this; I think it was more people projecting onto him what they wanted to project.) Obviously Edwards would have been catastrophic; had he won the nomination, the most important person in the country would be John McCain's doctor.

But I'm not particularly surprised by Obama's first year. I would have preferred a bigger stimulus, but the one he got was a step in the right direction; I would have preferred a different health care bill, but the one he got (almost) was far better than nothing; and I think he has been far too soft on Wall Street, both during the crisis and after. I don't like Waxman-Markey (I prefer Cantwell-Collins), but it wouldn't surprise me if Obama went with it (assuming it could pass the Senate, which is a long shot at this point).

This is basically what we voted for, like it or not.

*By James Kwak*



## Paul Krugman For The Fed

Simon Johnson | 23 Jan 2010

The case for Ben Bernanke's reappointment was weak to start with, weakened with his hearings, and is now held together by string and some phone calls from the White House. Bernanke is an airline pilot who pulled off a miraculous landing, but didn't do his preflight checks and doesn't show any sign of being more careful in the future – thank him if you want, but why would you fly with him again (or the airline that keeps him on)?

The support for Bernanke in the Senate hangs by a thread – with Harry Reid providing a message of support, albeit lukewarm, after the markets close. The White House is telling people that if Bernanke is not reconfirmed there will be chaos in the markets and the economic recovery will be derailed. This is incorrect.

The danger here is uncertainty – the markets fear a prolonged policy vacuum. Fortunately, there is a way to address this. Ben Bernanke should withdraw and the president should nominate Paul Krugman to take his place.

Paul Krugman is an expert on monetary policy – he wrote the classic paper on balance of payments crises (and probably could have got the Nobel Prize just for that), his work on Japan in the 1990s shaped everyone's thinking of how to handle potential deflation, and his assessment of the crisis and needed response in fall 2008 was right on the money.

Krugman is known to many academics as a trade theorist and as a pioneering modeler of growth with increasing returns. But just because Keynes wrote eloquently on Indian currency reform did not prevent him from also understanding what had gone wrong with the world economy – and how to substantially fix it.

Krugman also has exactly the paper trail that you would like to see from any potential Fed chair. He has written pointedly and with complete clarity about all the leading policy issues of the day.

There is no question where he stands, for example, on "too big to fail" financial institutions: he's opposed and would push for fundamental financial reform and tough oversight.

Big banks, without doubt, would be appalled. But the "Greenspan fallacy" was always that no one else could do his job and even

considering an alternative would be destabilizing. Look at the mess that got us into.

What the markets really care about is what the Fed does, with regard to both interest rates and regulation. What we need is a Fed chair who can be trusted to nurture the recovery – find me the business person who is opposed to that - without allowing too big to fail institutions to remain so big and so dangerous that they can destabilize the system.

And don't think that Krugman can't raise interest rates if he really sees inflation coming – even if the danger, for example, is not picked up by conventional measures. He is tough minded, not afraid to take stands long before they are fashionable, and confident that others will soon come to their senses.

Would he be a “populist” choice? Absolutely not. He would be a popular choice, no doubt, but he is also many technocrats’ favorite thinker and a person whose credentials and proven policy opinions speak for themselves. No one would question the independence of the Fed with him at the helm.

Would Krugman be opposed by the Republicans? Yes, potentially. And there could be quite a fight in the Senate – entirely of the Republicans making. But if they oppose his appointment – despite his qualifications and in the face of our weak economy – what signal would that send about their priorities?

The president said on Thursday he is (finally) willing to fight the big banks. He's an effective fighter and, with enough support, he can win. But is any part of his agenda at this point really advanced by winning the reappointment of Ben Bernanke?

*By Simon Johnson*

## Two Good Thoughts About Financial Reform

James Kwak | 23 Jan 2010

From Economics of Contempt (hat tip Brad DeLong):

“The single best thing we could do for financial reform: Triple the budgets of all financial regulatory agencies. Immediately. Regulators are woefully understaffed; this is fact.”

I’m not sure about “single best,” but otherwise dead on. The agencies that are self-funding out of their businesses (banking for the Federal Reserve, insurance for the FDIC) have been less bad than the ones that are not (OCC, OTS).

“Some people will claim that it’s impossible to distinguish between market-making trades and proprietary trades, but that argument is completely baseless. The banks themselves *already distinguish* between their market-making trades and their proprietary trades, as there’s a whole different set of rules for proprietary versus market-making trades. So don’t be fooled by that argument.”

The context here is that, technically speaking, the ordinary business of executing trades at the request of clients does involve some risk for the dealer. EoC talks specifically about market-making, where a dealer has an obligation to post a bid and an ask for a certain security. Since it can’t balance it the buy and sell orders instantaneously, it generally carries “inventory,” meaning that it’s long that security. But his point is that banks already divide their business along these lines, so saying they can’t is hogwash. Obama’s proposal *might* give banks an incentive to try to sneak one kind of trading under cover of the other, but that’s something that could be policed; it’s not like it’s theoretically impossible to distinguish the two.

By James Kwak

## Paul Krugman for Fed Chair: “Crazy”

James Kwak | 23 Jan 2010

Paul Krugman says that Simon’s idea that he should be chair of the Fed is “crazy.” Krugman’s point is either that he wouldn’t be confirmed or that he wouldn’t be able to bring the Open Market Committee along. Maybe he’s right about the former; a Republican filibuster does seem reasonably likely.

I don’t think he’s right about the latter; or, more precisely, I don’t think it matters. The FOMC is, on paper, a democratic body: they vote. There is a tradition that the votes are generally unanimous because of the perceived importance of demonstrating consensus. I don’t know how old this tradition is; it was certainly in place under Greenspan. But everyone knows that the members of the FOMC disagree about many things; that’s why the various bank president members go around giving speeches objecting (not in so many words) to the FOMC’s decisions. Given that we all know there are debates involved, how important is this fiction of consensus?

Put another way, I think it would actually be *good* if we had a non-unanimous FOMC and even a FOMC that voted against its chair now and then. That would help get us away from this ideology of the all-knowing, all-powerful Fed chair, which is clearly wrong and certainly dangerous. So if Krugman couldn’t get everyone on the committee to back him, who cares? He’s a smart man, and by being on the committee he will move it in his direction, even if not all the way there. As I’ve said before, the job of Fed chair should be a little more like being chief justice of the Supreme Court and less like being Dictator of All Economic and Monetary Policy, which is what it almost was under Greenspan. That’s why I think the administration can be very open-minded about this job. We want to get *away* from depending on one person, which means we have to stop acting like the Fed chair has to be a demigod.

More important, is this a serious “I don’t want to be considered,” or is it the Bob Kelly variety? Bob Kelly, CEO of Bank of New York Mellon, said he wasn’t interested in being CEO of Bank of America on November 4. Then on December 11, it turned out he was talking to Bank of America about being CEO. What changed in the meantime? Bank of America paid back its TARP money, eliminating restrictions on . . . executive compensation.

Unfortunately, I think Krugman is serious. I mean, why would anyone in his or her right mind want to be Fed chair?

**Update:** StatsGuy nominates Michael Woodford.

*By James Kwak*

## Fun Reading About Big Banks

James Kwak | 23 Jan 2010

Uncle Billy pointed out this post by The Epicurean Dealmaker, which he described as “smoking.” TED actually is an investment banker (or an excellent imitator of one, down to the expensive tastes), so he can say things in more detail and more convincingly than I. Like this:

“But the assertion that large, multi-line financial conglomerates provide customers with services no smaller institutions can deliver is pure poppycock. The mid-1990s concept of globe-striding financial supermarkets has been completely discredited, most notably by their sad-sack poster child, Citigroup. Wholesale institutional clients *make a point* of using more than one investment or commercial bank for virtually *all* their financial transactions, no matter what they are. In fact, the bigger the deal, the more banks the customer usually uses. This is because banking clients want to 1) spread transaction financing and execution risk across multiple service providers and 2) make sure none of these oligopolist bastards has an exclusive right to grab the client by the short and curlies.”

There's more.

By James Kwak

## Is The “Volcker Rule” More Than A Marketing Slogan?

Simon Johnson | 24 Jan 2010

At the broadest level, Thursday’s announcement from the White House was encouraging – for the first time, the president endorsed potential new constraints on the scale and scope of our largest banks, and said he was ready for “a fight”. After a long tough argument, Paul Volcker appeared to have finally persuaded President Obama that the unconditional bailouts of 2008-2009 planted the seeds for another major economic crisis.

But how deep does this conversion go? On the “deep” side is the signal implicit in the fact that Volcker stood behind the president while Tim Geithner was further from the podium than any Treasury Secretary in living memory. Where you stand at major White House announcements is never an accident.

Increasingly, however, there are very real indications that the conversion is either superficial (on the economic side of the White House) or entirely a marketing ploy (on the political side). Here are the five top reasons to worry.

1. Secretary Geithner’s spin on the Volcker Rule, Thursday night on the Lehrer NewsHour, is in direct contradiction to what the president said. At first, it seemed that Geithner was just off-message. Now it is more likely that he is (still) the message.
2. The White House background briefing on Thursday morning gave listeners the strong impression that these new proposals would freeze the size of our largest banks “as is”. Again, this is strongly at odds with what the president said and seemed – at the time – to indicate insufficient preparation and message drift. But who is really drifting now, the aides or the president?
3. At the heart of the substance of the “Volcker Rule,” if the idea is literally to freeze the banks at or close to their current size, this makes no sense at all. Why would anyone regard twenty years of reckless expansion, a massive global crisis, and the most generous bailout in recorded history as the recipe for creating “right” sized banks? There is absolutely no evidence, for example, that the increase in bank scale since the mid-1990s has brought anything other than huge social costs – in terms of direct financial rescues, the fiscal stimulus needed to prevent another Great

Depression, and millions of lost jobs. On reflection, perhaps the president really still doesn't get this.

4. Since Thursday, the White House has gone all out for the reconfirmation of Ben Bernanke, whereas gently backing away from him – or at least not being so enthusiastic – would have sent a clearer signal that the president is truly prepared to be tough on big banks and their supporters. Unless Bernanke unexpectedly changes his stripes, his reappointment at this time gives up a major hostage to fortune – and to those Democrats and Republicans opposing serious financial reform.
5. As the White House begins to campaign for the November midterms, how will they answer the question: What exactly did they “change” relative to what any other potential administration would have done in the face of a financial crisis? How will they counter anyone who claims, citing Rahm Emanuel, that: “The crisis is over, and we wasted it.” No answer is yet in sight.

The Geithner strategy of being overly nice to the mega-banks was not good economics and has proven impossible to sell politically – the popular hostility to his approach is just common sense prevailing over technical mumbo jumbo.

But selling incoherent mush with a mixed message and cross-eyed messengers could be even worse.

*By Simon Johnson*

## Q&A with Simon at The Atlantic

**James Kwak** | 25 Jan 2010

Daniel Indiviglio did a Q&A with Simon, mainly on financial regulation. [Here it is.](#)

(Sorry there isn't much today . . . proofreading.)

*By James Kwak*

## Tim Geithner Says to Leave Your Money at Big Banks

James Kwak | 25 Jan 2010

But he's not sure why. During an [interview with Mike Allen of Politico](#), Tim Geithner said that the [Move Your Money](#) campaign is a bad idea, but didn't actually give a reason why. Here's the whole segment of the interview (beginning around the 3:30 mark):

Allen: "Arianna Huffington has been urging Americans to move money from big banks to neighborhood banks. Do you think that's a good idea?"

Geithner: "I don't, but I do think the following is important that people recognize."

"But wait, why is that a bad idea?"

"Well, let me say this. Customers of financial institutions should be very demanding in the kind of service they expect, the kind of products they get, the disclosure banks offer, the basic fairness in dealings. So I'm very supportive of customers of banks, of investors in banks, creditors of banks, holding them to very high standards. That's something that's very appropriate."

[Those all sound to me like good reasons to move your money out of big banks. At least, they were [for me](#).]

"Is that campaign hurting?"

"I'm not concerned with her campaign. I agree with the basic principle, again, that we've been through a period where I think people are right to expect more of their financial institutions."

So why exactly is moving your money out of big banks a bad idea?

*By James Kwak*

## The “Professional Investor” Excuse

James Kwak | 26 Jan 2010

On Tap takes on the often-used fiction that investment banks have done nothing wrong because they were simply dealing with professional investors who knew what they were getting into. He uses the always reliable device of taking aim at something on the Wall Street Journal op-ed page (a column by Holman Jenkins, in this case)—not only do people actually believe these things, but they get column-inches in one of America’s best newspapers.

To Jenkins, OT responds:

“Generally speaking and contrary to popular belief, caveat emptor is not a well-established legal principal . . . Professionals in other fields have many avenues of recourse when they are sold a defective product—just because you’re an expert doesn’t mean you’ve disclaimed all warranties.”

OT also takes on the argument that banks are always betting against their clients, and the clients should know that.

*By James Kwak*

## The Second Clinton?

James Kwak | 26 Jan 2010

On the one hand, last week's Volcker-fest signaled that the Obama administration wants to get tough on Wall Street. Given that they almost certainly don't have the votes in the Senate (and probably not the House, either), this may have been a purely political calculation, and it remains to be seen how much substance lies behind the marketing. But even so it was probably smart politics, since it forces Republicans to either go along (which ain't gonna happen) or come out in favor of hedge funds and proprietary trading.

On the other hand, what the —? The New York Times reports that Obama is planning to call for a three-year freeze on non-security discretionary spending, which means everything except Medicare, Medicaid, Social Security, the Defense Department, Homeland Security, and the VA—that is, everything except the vast majority of the budget. This at a time when the unemployment rate is at 10%.

Ezra Klein describes what is likely to go wrong here.

"The administration will target worthless programs, like agricultural subsidies, in order to preserve good programs. But the reason worthless programs live in budget after budget is they have powerful backers. And those backers will rush to Congress to protect their profits. . . .

"Now you've removed some of the cuts, but you still want to hit the overall target. So the cuts could get reapportioned to hit programs that lack powerful constituencies. Many of those programs help the poor."

Brad DeLong, who is usually more sympathetic to the administration than I, calls it "Dingbat Kabuki," and then he really gets going:

"This is a perfect example of fundamental unseriousness: rather than make proposals that will actually tackle the long-term deficit—either through future tax increases triggered by excessive deficits or through future entitlement spending caps triggered by excessive deficits—come up with a proposal that does short-term harm to the economy without tackling the deficit in any serious and significant way."

To me, it sounds like Obama has decided to imitate Bill Clinton, except that he's going to skip 1994 and jump right to 1995-1996—the years that gave us welfare reform and the Anti-terrorism and Effective Death Penalty Act, among other things. Deficit reduction is a classic "Third Way" policy, but by doing it this way Obama is ceding ground to the government-haters (who just want to cut spending) without getting anything (future tax increases, or votes for health care reform) in return. As DeLong says, "it would be one thing to offer a short-term discretionary spending freeze (or long-run entitlement caps) in return for fifteen Republican senators signing on to revenue enhancement triggers. It's quite another to negotiate against yourself and in addition attack employment in the short term."

Presumably Volckerama was about attracting the base, and this is about appealing to independents who care about the deficit because . . . well, because they always care about the deficit. I've said before that the Obama administration hasn't gotten the credit it deserves for being serious about our long-term debt problem, and I'm sure they're frustrated about what happened to the right solution (health care reform). But this feels like they've given up on real solutions and are just trying to score points.

**Update:** The usually understated Mark Thoma thinks along similar lines (in uncharacteristically not understated tones):

"We get cheap political tricks that are likely to backfire. How will this look, for example, if there's a double dip recession, or if unemployment follows the dismal path that the administration itself has forecast?

"This seems to be a case of the former Clinton people in the administration trying to relive their glory days instead of realizing that those days are gone, the world is different now and it calls for different solutions.

"I wasn't in favor of having so many Clinton administration people in this administration, and nothing so far has caused me to change that assessment. They're nothing but trouble."

**Update 2:** I really meant it when I said that the administration hasn't gotten enough credit for the deficit-reducing efforts it put into health care reform. Peter Orszag is trying to make that case publicly: "The bottom line is the bill that is currently on the Senate floor contains more

cost containment and delivery system reforms in its current form than any bill that has ever been considered on the Senate floor period."

Brad DeLong's post linking to that article is titled, "Why Aren't Deficit Hawks Telling the House to Pass the Senate Health Care Bill?"

*By James Kwak*

## Good for Goldman

James Kwak | 27 Jan 2010

Searching through my RSS feed\*, I observe that not many people have commented on Goldman Sachs's stunning compensation announcement (except for Felix Salmon), perhaps because it came out on the same day as the "Volcker Rule," perhaps because bloggers are not wired to say nice things about Goldman. But I'm going to make the sure-to-be-unpopular statement that Goldman did the right thing here.

We all know that Goldman made a lot of money last year: \$35.0 billion before compensation and taxes, on my reading of the income statement (that's pre-tax earnings plus compensation and benefits). Many people think that it made that money because of government support, but that's beside the point here; right now, this is purely a question of dividing the spoils between employees and shareholders.

Historically, investment banks have given a large proportion of the profits (here, meaning before compensation and taxes) to the employees. For example, in 2007 Goldman gave \$20.2 billion out of \$37.8 billion to its employees, or 53%. There are undoubtedly many reasons for this. One reason is the idea that investment banking is a business that depends on individual "talent," and therefore employees have to be paid their marginal product or they will leave for other firms. More insidiously, investment banking executives tend to see their employees as younger versions of themselves, which creates a sense of solidarity; at traditional investment banks, the management committee was composed of partners who worked their way up through the ranks. Contrast this to, say, Wal-Mart, where top management has very little in common (socially, educationally, economically, politically, etc.) with the vast majority of their employees.

As a result, investment bankers are overpaid. Now, before all the bankers get all indignant on me, let me say that bankers should make more money than average people, at least according to the normal rules of our society; for one thing, they are, on average, better educated than most people. (As I've written before, I don't think there's any moral reason why people should make more money simply because they are better educated, or have unique skills, or are more intelligent, or work harder; but that's the way the world works, and most people are OK with that in principle.)

How much more overpaid? I've previously written about the paper by Thomas Phillipon and Ariell Reshef on wages in the financial industry. According to Figure 10, you would expect wages in finance to be about 30% higher than in the economy at large because of higher education and lower job security; yet, also according to Figure 10, wages in finance were over 70% higher than average earlier this decade. 40 percentage points divided by 1.7 implies that wages should come down by about 25%. This is an industry-wide figure, however, and recent wage growth has been much higher in investment banking than in the rest of the industry (largely banking and insurance), so 25% is probably a very low figure for investment banking. But without more data, that's the best I can do.

Now, Philippon and Reshef's data only go through 2006. In 2006, Goldman paid \$16.5 billion out of \$31.1 billion of its profits to employees (53%, the same as in 2007), which worked out to about \$620,000 per employee. (In 2007, that figure was about \$660,000.) Subtracting 25%, we get that Goldman employees should have earned about \$470,000 on average. This is probably still much too high, because that 25% figure is undoubtedly far too low for investment banking. But it's a starting point.

Now, what did Goldman do for 2009? Through September, they had already set aside \$16.7 billion for compensation, a 57% payout ratio; annualized, that comes to a stunning \$22.3 billion, or \$700,000 per employee. In Q4, however, they did the unthinkable; it *reduced* its compensation expenses by \$500 million.\*\* This lowered the annual compensation pool to \$16.2 billion, or \$500,000 per employee, and lowered the payout ratio to 46%.

In their press release, Goldman trumpeted the fact that compensation was down 20% from 2007 and the payout ratio was the lowest ever.\*\*\* They neglected to mention that total compensation was the same as in 2006 and over 30% higher than 2005, when per-employee compensation was \$500,000. (So on a per-employee basis, we've just rolled the clock back to 2005.) But still, \$500,000 is better than \$660,000 (2007) and a lot better than \$700,000 (2009 through September).

I'm sure most people wrote this move off as a public relations stunt, and maybe it was. Maybe management leaked to employees that 2010 bonuses will be extra-good to make up for 2009. But there's another possibility, as Salmon pointed out, which is that Goldman realized it simply doesn't have to pay its employees as much. Goldman is the premier investment bank in the world, and the gap between it and its

rivals has gotten much bigger; if someone is unhappy with his bonus, where is he going to go? Citigroup? Bank of America Merrill Lynch? If Goldman's management team really wants to maximize shareholder value, then this is exactly what they should be doing. (The big problem, as the New York Times points out, is other banks that are paying big bonuses despite having bad years—like Citigroup, whose payout ratio is over 100%.)

The test, of course, will be next year. Goldman should reduce its per-employee compensation expenses even further, and should try to push the industry to a new equilibrium where the payout ratio is in the 30-40% range and average compensation for investment bankers is in the \$300-400,000 range. And Goldman's shareholders should apply pressure to make this happen; basically, they should try to squeeze labor.

Will they? Shareholder governance is something we usually celebrate about our economy. But I wonder if it works for investment banks. I wonder because the institutional investors that control most of the shares are *the same kind of people* as the bankers who work at those banks. Yes, it's the buy side (people who buy securities) versus the sell side (people who sell them), but they went to the same colleges, they go to the Hamptons together, their kids go to the same schools, and so on. It's probably easier for an institutional investor to swallow \$600,000 per year compensation at Goldman than it is to swallow \$10 per hour at Wal-Mart. Maybe class bonds outweigh economic interests.

My prediction is that this is just a PR stunt and next year (assuming it is a good one for the banks), per-employee compensation at Goldman returns to at least \$600,000 and maybe \$700,000. But I would love to be wrong.

\* One of the best things about reading news and blogs in an RSS reader like Google Reader is that it works like a perfectly-targeted meta-search: You can search your preferred information sources all at once in one place, as opposed to using Google web search where you get the entire universe in one haphazardly-ordered list.

\*\* This means that it reduced its bonus pool by even more, since during the quarter it had to accrue its employees' ordinary salaries and benefits; assuming \$40,000 per employee, that comes to \$1.2 billion, meaning that it reduced the bonus pool by \$1.7 billion.

\*\*\* Goldman uses compensation divided by net revenues, which gives them different percentages from mine, but the substance is the same.

By James Kwak



## The Next Subpoena For Goldman Sachs

Simon Johnson | 28 Jan 2010

Yesterday's release of detailed information regarding with whom AIG settled in full on credit default swaps (CDS) at the end of 2008 was helpful. We learned a great deal about the precise nature of transactions and the exact composition of counterparties involved.

We already knew, of course, that this "close out" at full price was partly about Goldman Sachs – and that SocGen was involved. There was also, it turns out, some Merrill Lynch exposure (affecting Bank of America, which was in the process of buying Merrill). Still, it's striking that no other major banks had apparently much of this kind of insurance from AIG against their losses – Citi, Morgan Stanley, and JPMorgan, for example, are not on the list.

This information is useful because it will help the House Oversight and Government Reform Committee structure a follow up subpeona to be served on Goldman Sachs with the following purpose:

1. Did Goldman actually deliver the security that was insured? Ordinarily when you close out a contract of this nature – particularly at par – you turn over the insured security in return for the payment. The insurer pays in full but is left holding a security; if this recovers in price, the insurer recoups some of the loss. But if Goldman was using AIG as reinsurance, which is what some news reports suggest, it did not have any security to turn over. (Remember that with CDS – unlike cars – you can insure something that you don't own).
2. If Goldman did not turn over a security, then how was it determined that the security had essentially zero value – which was the rationale for the payment really being made at par? Was this assessment provided by Goldman or by some independent third party? These were highly illiquid markets, so there was generally no widely quoted price that could be used.
3. How did this valuation process differ from standard practice among market participants – when close out under such conditions is typically not at par? If the Fed effectively allowed Goldman unilaterally to declare a security worthless and to demand payment in full, we have a major problem.
4. Secretary Geithner claimed yesterday that, if payment had not been made in full, the economic consequences would have been

dramatic. To assess this claim, we need to see the value of these claims on Goldman's books prior to this bailout transaction. Best practice would suggest that Goldman was not carrying this asset at face value – as it is an articulate proponent of mark-to-market and there must have been a reasonable expectation that AIG would not pay off in full. Therefore the transaction represented a windfall gain for Goldman shareholders and insiders – rather than something that in any sense “saved the day” for the financial system.

5. As the evidence stands currently, the entire AIG transaction therefore appears to have been structured in such a way as to benefit primarily Goldman – although, for fair comparisons, we should obtain parallel details from other counterparties. What was the entire timing and content of interactions between Goldman and the Fed on this matter? Who exactly designed the deal and with which advisers?

The House Oversight and Government Reform Committee has done an extraordinary job peeling back several layers of a potentially rotten onion. They need to follow the lead provided by this evidence and ask the next hard round of questions.

Some of these issues are rather technical but evidence either way will speak directly to accusations of favoritism and unreasonable government behavior. It is time to get fully to the bottom of this matter.

*By Simon Johnson*

# A Colossal Failure Of Governance: The Reappointment of Ben Bernanke

Simon Johnson | 28 Jan 2010

When representatives of American power encounter officials in less rich countries, they are prone to suggest that any failure to reach the highest standards of living is due in part to weak political governance in general and the failure of effective oversight in particular. Current and former US Treasury officials frequently remark this or that government “lacks the political will” to exercise responsible economic policy or even replace a powerful official who has clearly become a problem.

There is much to be said for this view. When a minister or even the head of a strong government agency is no longer acting in the best interests of any country – but is still backed by powerful special interests — who has the authority, the opportunity, and the fortitude to stand up and be counted?

Fortunately, our constitution grants the Senate the power to approve or disapprove key government appointments, and over the past 200 plus years this has served many times as an effective check on both executive authority and overly strong lobbies – who usually want their own, unsuitable, person to be kept on the job.

Unfortunately, two massive failures of governance at the level of the Senate also spring to mind: first, the strange case of Alan Greenspan, which stretched over nearly two decades; second, Ben Bernanke, reappointed today (Thursday).

Greenspan, as you recall, was worshiped as some sort of economic magician. Even his most asinine comments were seized upon by a legion of acolytes. Instead of providing meaningful periodic oversight, every Senate hearing was essentially a recoronation.

And now we can look back over 20 years and be honest with ourselves: Alan Greenspan contends for the title of most disastrous economic policy maker in the recent history of the world.

Some on Wall Street, of course, would disagree – arguing that the financial sector growth he fostered is not completely illusory, that we have indeed reached a new economic paradigm due to the Greenspan tonic of deregulation, neglect, and refusal to enforce the law. Prove the ill-effects, they cry.

What part of 8 million net jobs lost since December 2007 do you still not understand?

And now the same Greenspanians and their fellow travelers rally to the support of Ben Bernanke's troubled renomination. Certainly, they concede that Bernanke was complicit in and continued many of Greenspan's mistakes through September 2008. But, they argue, he ran a helluva bailout strategy after that point. And, in any case, if the Senate had refused to reconfirm him - financial sector representatives insist - there would have been chaos in the markets.

Take that last statement at face value and think about it. Have we really reached the situation where the Senate as a body and individual Senators - accomplished men and women, who stand on the shoulders of giants - must bow down before financial markets and high-ranking executives who are really just talking their book?

Here's what markets really care about: credible fiscal policy, sufficiently tough monetary policy, and the extent to which big banks will be allowed to run amok - and then get bailed out again.

Reappointing Ben Bernanke solves none of our problems. In fact, given his stated intentions, a Bernanke reappointment implies larger bailouts in the future - thus compromising our budget further with contingent liabilities, i.e., huge payments that we'll have to make next time there is a crisis. What kind of fiscal responsibility strategy is this?

Rather than messing about with a meaningless (or damaging) freeze for part of discretionary spending, the White House should fix the financial system that - with too big to fail at its heart - has directly resulted in doubling our net government debt to GDP ratio from 40 percent (a moderate level) towards 80 percent (a high level) in a desperate attempt to ward off a Second Great Depression.

If you think we can sort out finance with Ben Bernanke at the helm, it was sensible to reappoint him. But when the time comes for members of the Senate themselves to be held accountable, do not be surprised if people point out that pushing Bernanke through - come what may - was the beginning of the end for any serious attempt at reform.

Ultimately, sensible democratic governance prevails in the United States. Sometimes it takes a while.

*By Simon Johnson*

## Steve Jobs's Magic

James Kwak | 29 Jan 2010

I know that no one out there really wants to hear my thoughts on new personal technology, but no one's forcing you to read this. So here are my first thoughts on the iPad, Apple's new 10" tablet.

The resurgence of Apple in the last decade has been based on its ability to simply design and build better products than anyone else, in part because it does a better job of understanding what consumers actually want than anyone else. They are also extremely good at marketing and selling; who would have imagined that Apple would also turn out to be better at *retail* than any other electronic company? But I wonder if, with the iPad, the Steve Jobs magic is running low.

Of course, as David Pogue says, we are now in Phase 2 of any new Apple product: "the bashing by the bloggers who've never even tried it." The theory is that because Apple knows what we want better than we know ourselves, the thing will sell, despite its obvious shortcomings. In the case of the iPad, the obvious shortcoming is that it can't replace a cell phone (not only does it not make calls, it's simply too big to whip out when you need to make a call) or a laptop (unless you use your laptop solely to consume content). Yes, you could add a physical keyboard, but then you've got a laptop with a stripped-down operating system. (It has other major shortcomings, like no Flash and no multitasking, but those will no doubt be fixed in later versions.) So Apple has to convince people they need yet another gadget.

You could argue that this is what they did with the iPod, but my recollection is that MP3 players were already a rapidly-growing category at the time; Apple simply built a much, much better one. In addition, the iPod is *small*, so adding it to your panoply of gadgetry is physically easy; the same is not true of the iPad. (Apple's other great products—the iMac, the MacBook, the iPhone—are simply better versions of products people already knew they needed.)

The best evidence that the iPad could be a big success is the e-reader market (Kindle, Nook, etc.). After all, people do already carry around books and magazines, and many of them have decided that a Kindle is a lighter and more flexible way to do that. And people who use their laptops mainly to surf the Internet and write short emails could downgrade to the iPad. So maybe Apple is trying to repeat the success of the iPod in that market. But as I recall, the killer early features of the

iPod were the click wheel (which made it possible to browse through a large library on a small screen) and, especially iTunes—not the store at first, but the fact that Apple was the first company to make it really easy to rip CDs and synch them to your MP3 player (even if it defaulted to a proprietary format at the time). I don't think there's anything comparable here, since the Kindle has already nailed the content distribution problem, and has the biggest catalog. And to be truly useful, the iPad requires you to pay \$30/month to use AT&T's already overloaded network.

The iPad is also going to go the "open platform" route, letting developers create applications for it, which was a large though probably overrated element in the iPhone's success. But while this was a major step for phones, the iPad will be competing with tablets built using Windows and Android, which were always designed to be open platforms for development.

So, in short, a product that most people don't need, except for one market where it's behind. That said, I think it will still be a success, though not nearly as big as the iPod or iPhone. I think so for two reasons: first, the product probably is just better than anything else in the category; and second, the Apple fan base is so big and so devoted that it will have blowout initial sales and then build momentum of its own. As developers figure out new things to do with tablets, they will probably figure them out first and best on the iPad, not whatever bloated and slow version of Windows Microsoft chooses to put on these things.

Personally, I would rather they had put the effort into making a better, faster MacBook Air, but that's just me.

*By James Kwak*

## A Constitutional Amendment?

James Kwak | 29 Jan 2010

In the wake of the Supreme Court's decision in *Citizens United* to expand the ability of corporations\* to pay for election-related communications, prominent law professor Lawrence Lessig is calling for a constitutional amendment to protect elections from the influence of money. The text of the proposed amendment isn't done yet, but the goal is to protect Congress from the influence of money.

Lessig's argument is simple: Congress is fundamentally (though, thanks to the Supreme Court, legally) corrupt, and most people think it is corrupt, which makes it hard for elected majorities to effect change and also undermines people's faith in their government. Commenting on *Citizens United*, he said, "The surprise, and in my view, real cause for concern, however, was how little weight the Court gave to the central purpose of any fair election law: the purpose to protect the institutional integrity of the democratic process. That value seemed invisible to this Court, as if we didn't now live in a democracy in which the vast majority has lost faith in their government." Since the Court's preferred stick for blocking campaign finance reform is the First Amendment, the only thing that can stop them is a new amendment.

I think campaign finance reform is a hugely important issue, but in the past I have been skeptical that it could be solved. I have also been skeptical of constitutional amendments in this area, because my belief is that each major party will evaluate any proposed amendment for its impact on its own political power, and one or the other will be able to muster thirteen states to block the amendment. In 1971, the 26th Amendment lowered the voting age from twenty-one to eighteen, but I find it hard to imagine that such an amendment could be ratified today; since the young vote are, for example, disproportionately in favor of same-sex marriage, I can't see the Republicans going along. Partial proof is in the plight of the District of Columbia, which clearly should have a representative in Congress (the license plates in DC say "taxation without representation"), with more people than Wyoming. But since everyone knows that that representative would be a Democrat, there is no chance of such an amendment passing today. (Proposals that a representative for DC be balanced by an extra representative for Utah just prove my point.)

Lessig is trying to make his proposed amendment a bipartisan initiative, and that may turn out to be a successful strategy. Perhaps disillusioned liberals and angry conservatives could make common cause—although bear in mind that much of the massive campaign spending that exploits current campaign finance loopholes comes precisely from these two extremes. But it's a huge problem, and Lessig is probably right that this is the only real solution. So I'm strongly in favor; I just wouldn't put too much money on it.

\* And unions, people always point out. But the unions themselves were by and large *against* the Supreme Court's decision in *Citizens United*, because they know the corporations have much, much more firepower.

*By James Kwak*

# The Wasted Opportunity

James Kwak | 30 Jan 2010

I thoroughly enjoyed reading *The End of Influence* by Stephen Cohen and Brad DeLong.\* For one thing, it's not specifically about the financial crisis (although that does play a role), so you don't have to read the nineteenth explanation of how a CDO works or what a NINJA loan is. For another, it's short—only 150 pages, and small pages at that—and easy to read, so it will probably jump your queue of books to read and you can cross it off your list in just a couple of hours.

Despite being a short book, it's about a lot of things. The most obvious is the much-bemoaned fact that the U.S. is now a huge debtor nation and is unlikely to maintain its status as the world's importer of last resort indefinitely, and what that all means. The most central, however, is probably the global shift away economic neoliberalism—the idea that governments should withdraw from the economic sphere and allow free market forces to work their magic, symbolized by the recent effort to convince sovereign wealth funds to behave like ordinary, return-seeking institutional investors (see pages 85-89). Cohen and DeLong show that the last few decades of neoliberalism are really just a historical blip and that most of history—including most of the post-World War II—saw plenty of government intervention, even industrial policy, in countries like France (TGV, Airbus, etc.) and the United States (via the Pentagon). They see a resurgence of industrial policy all around the world (although it never really went away—see China, for example), and even if it often ends badly, it is something we will have to reckon with.

If the book isn't centrally about the financial sector and the financial crisis, though, they still have a minor starring role. In their account, the recent period in which developing countries wanted to lend us their dollar surpluses gave us a great opportunity: "It gave America the opportunity, while absorbing more and more routine manufacturing from Asia at the expense of those same industries at home," to shift its own economy into what should have been the 'sectors of the future.'" Instead, though we shifted our economy into finance. "The freedom of action that the United States enjoyed because it had the money was squandered" (pp. 12-13).

Cohen and DeLong recount (in admirably condensed form) the charges generally leveled against the financial sector, but they also point out something that often is overlooked:

"[Finance] had achieved the cultural dominance that so often goes hand-in-hand with economic dominance: its gigantism and ubiquity, its tonic impact on the entire economy, its fabulous success, the sheer gushing of money, its generous funding for elected politicians, its seconding of its top executives to top posts throughout the regulatory apparatus of government, and its simple and powerful message of 'let the market work its magic.' It was so easy" (pp. 112-13).

Cohen and DeLong do not make the financial sector the sole villain in their story. Another one is inequality: "Faced with stagnant incomes, seeing themselves falling behind those above them on the income scale, and spending their evenings watching *Lifestyles of the Rich and Famous*, what did the average American family do?" (p. 107). They worked more, and they borrowed more.

So where do we go from here? Although their book is all about the decline of U.S. financial power, Cohen and DeLong are far from prophets of doom. America simply needs to become a little bit more like a normal country—only a little, because we are still the world's largest economy and its only superpower. "A drop in the value of the dollar, even a big drop, is not the end of the American economy" (p. 100). We don't have as much weight to throw around in international meetings. I agree.

This is me talking now, not Cohen and DeLong: There is a lot of hand-wringing over global imbalances, but the answer is quite simple: the dollar needs to fall. Imported goods will get more expensive, but domestic goods won't, and we'll adapt. We won't be able to dictate to the world as much as we used to, but frankly that's a good thing, given how many other parts of the world we have messed up in our history and how wrong our extreme free market ideas turned out to be. In the long, long, long term, maybe the United States will become just another country—a larger, somewhat richer version of Canada, or Belgium, or Denmark, or something like that. We could do a lot worse.

\* Which I bought myself, two days before someone offered me a free copy.

By James Kwak

## “Populism”

Simon Johnson | 30 Jan 2010

Amidst otherwise strong coverage of the growing debate around the nature of finance and the power of big banks, a surprisingly high number of journalists continue to misuse the word “populism”.

For example, in an article on criticism of bankers at Davos, the Wall Street on Saturday morning reported that President Sarkozy of France delivered a “populist broadside” when he said,

“That those who create jobs and wealth may earn a lot of money is not shocking. But that those who contribute to destroying jobs and wealth also earn a lot of money is morally indefensible.”

The implication, of course, is that some politicians are pandering to “the people” vs. “the elites” – part of a long-standing theme in some interpretations of democratic political conflict. While elites invest and engage in productive activities, the argument goes, plebians from time to time demand excessive income redistribution or punitive taxation or other measures that would undermine productivity and prosperity.

Or, as President Obama said in March 2009, “My administration is the only thing between you and the pitchforks.”

Such language reveals a complete misunderstanding of our current situation. (Matt Taibbi has this right, but doesn’t go far enough.)

The problem we face is not that the broader population wants pointless or destructive revenge on a financial elite that has done well. Nor is it the case that, if left largely to its own devices, our major banks will guide us back along the path to sustainable growth.

The consensus technocratic assessment is simple: We are smack in the middle of a doomsday cycle of repeated boom-bust-bailout (our version; the Bank of England’s take). The core issue – banks considered “too big to fail” – was not resolved in or after the crisis of 2008-09; if anything, as these banks have increased in size, the problem is now worse. We are therefore doomed to run headlong into another crisis.

This view is increasingly the developing consensus of most economists, many people active in financial markets (e.g., judging by reactions to this piece), top policy analysts from right and left, clear thinking central bankers, and pretty much anyone else who follows the news. Elites are deeply split along pro- and anti-big bank lines. Most

people who do not have a conflict of interest – i.e., don't work for big banks or the administration – want to see the most dangerous parts of our financial sector reined in and made safer.

Even leaders of the global nonfinancial business elite begin to understand what has happened and what comes next.

The fact that dramatic banking reforms would be popular does not make them populist. It merely means that a broad cross-section of our population has woken up to part of our appalling reality. Sure, they are angry – but with good reason, and the remedies they seek are entirely appropriate. Most of our elites are on the side of the broader population on this issue; only the diseased heart of Wall Street holds out.

Unfortunately, for whatever reason, the Obama administration remains convinced that merely tweaking our existing regulations is the only responsible way forward. Even their new “Volcker Rule” increasingly looks like superficial rebranding without new substance.

This will go nowhere – except to sad, unnecessary, and complete defeat in the November midterm elections.

*By Simon Johnson*

## Final Thoughts on Volckerfest 2010

James Kwak | 31 Jan 2010

The coming months will tell if the Volcker Rule and the prohibition on banks getting even larger will turn out to be substance or mere spin. I'm finally getting around to reading the transcript of the pre-announcement media briefing and I found a few things that were worth a smile.

1. On the cap on a single institution's share of liabilities: "The 10 percent cap on insured deposits exists in current law. It was put in place in 1994. And what we're saying is that deposit cap has served our country well." Um, then why did you waive it for JPMorgan Chase, Bank of America, and Wells Fargo?

2. Then here's the bit on how it's forward-looking only:

"It's designed to make sure that we don't end up with a system that some other countries have in the world, in which there's enormous concentration in their financial sector. So it's designed to constrain future growth. It's not about reducing liabilities within — the share within the existing structure."

End up with? The big four have 1/2 of the market for mortgages and 2/3 of the market for credit cards. Five banks have over 95% of the market for OTC derivatives. Three U.S. banks have over 40% of the global market for stock underwriting.

And again:

"It's designed to constrain future growth so that we don't have the extent of concentration you see in many other major advanced countries in the world that were — resulted in way more devastating damage to those countries during the financial crisis even than occurred here in the United States."

Who are these other mysterious "major advanced countries"? United Kingdom unemployment is 7.8%, up from 5.2% in December 2007 (when our recession began). Unemployment in Switzerland is 4.4%, up from 2.8% in December 2007. Unemployment in Germany is 8.2%, *down* from 8.3% in December 2007. What countries exactly are they talking about? Iceland?

3. "Q I'm wondering why these proposals were not included in the comprehensive legislation you proposed in June."

"The basic authority is provided in Chairman Frank's legislation, for regulators to break apart major financial firms or to address problems with risky activities to the extent that they cause the firm to act in an unsafe or unsound manner that threatens the financial system. So we worked very closely with Chairman Frank on that already."

Not exactly. The "basic authority" referred to must be the Kanjorski Amendment, which allows regulators to take action regarding a specific firm because it is a danger to the system (not just because it is a danger to itself). I don't recall the Kanjorski Amendment being in Treasury's initial regulatory proposal. (The Kanjorski Amendment is also hemmed in with all sorts of restrictions, like needing Tim Geithner's approval for any action affecting more than \$10 billion in assets.)

Or, more precisely, the answer is technically correct—they are claiming that they worked with Frank on the Kanjorski Amendment, which may be true—but it dodges the spirit of the initial question, which was "Why didn't you do this back in June?"

I know that administration officials have a tough job when they have to go out and spin new policies that (a) are significant changes from past policies and (b) may turn out not to be serious anyway. But that doesn't mean I have to give them a pass.

*By James Kwak*

## Move Your Politician's Money

Simon Johnson | 01 Feb 2010

I talked Sunday about Move Your Money with Guy Raz of NPR's Weekend All Things Considered ([summary](#); [audio](#) from about 3:45). We covered a lot of ground, from what's in it for individuals to shift towards community banks and credit unions (better service and lower costs, in many cases) to how this could begin to reign in Too Big To Fail financial institutions (slowly, but surely).

Unfortunately, there wasn't enough time to discuss what comes next – i.e., what happens when the location of political candidates' own money starts to matter. As early as this fall's primaries, expect to hear people ask politicians in debates and through various kinds of interactions: (1) where do you, personally, keep and borrow money, and (2), in all relevant cases, where did you put public money when it was up to you?

These questions strike to the heart of democratic responses against overly concentrated financial power throughout US history – a topic we take up in Chapter 1 of [13 Bankers](#).

In the 1830s showdown between elected officials and big banks, President Andrew Jackson went toe-to-toe with Nicolas Biddle of the Second Bank of the United States. Both sides won several rounds and finally it came down to this – could Jackson really move the money of the US government away from the Second Bank? He could and did. And despite being threatened – by bankers, naturally – with dire consequences, the US had a very good 19<sup>th</sup> century.

The essence of the second confrontation was neatly captured by the title of Louis Brandeis's 1914 book, *Other People's Money – and How the Bankers Use It*. Brandeis, a future Supreme Court Justice, saw clearly through the nature of the "Money Trust" – recognizing that its power was based, essentially, on its access to and control over funds deposited by regular people.

In effect, the industrial revolution had spread wealth and disposable income, but – through the rise of powerful investment banks – actually concentrated economic and political power.

Reformers struggled for several decades with how to constrain the biggest banks, without choking economic growth and while protecting individual depositors, in this new economy. The solution, reached after much difficulty and finally in response to popular demand, was the regulations of the 1930s.

From that time, until the early 1980s, financial empires based on retail deposits were greatly constrained in terms of the risks they could take – and without retail deposits, it was hard to become big enough to do serious damage to the economy.

After 30 years of deregulation and financial “innovation”, our problem today is rather different. The idea of banks being so big they can extract enormous resources from the state would have been incomprehensible to Jackson and ludicrous even to FDR – in their day the federal government did not have anywhere near enough resources to “save” massive failing banks as we have done in the past few years.

The essence of our current difficulties is that so many people – both in power and from all walks of life – still actually think our biggest banks are good for their customers and for society as a whole, so we must hold our noses and live with them. This view must be challenged, directly and repeatedly.

In this context, moving your own money is more than an important gesture, and if enough people get on board, it will make a difference. More likely, thinking hard –and talking with others – about your various monetary transactions also begins to change the rules of the political game. How can politicians claim to be against Too Big To Fail banks when they actually have an account or a credit card or a mortgage at one such offender? Shouldn’t state officials be held accountable for where they park the taxpayers’ funds? Which governor wants to risk reelection while heavily dependent on big banks? Who got what kind of commission last time a government body issued bonds?

This set of litmus tests can be seized on by left or right – both, in fact, can reasonably claim some inheritance from Jackson and Brandeis. Expect competition from all sides to prove their candidates are less beholden to the dangerous and debunked ideology of Reckless Finance.

Move your politicians.

*By Simon Johnson*



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