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Budget Sense and Nonsense

James Kwak | 01 Feb 2010

With the submission of the Obama administration's budget today, fiscal silly season is opening. President Obama already launched an opening salvo last week with his proposed freeze on non-security-related military spending, which amounts to a rounding error on the ten-year budget projections, which are themselves a rounding error on the long-term budget projections— at a time when unemployment is running at 10.0%. Fortunately, there is a partial saving grace, which is that the freeze does not set until until fiscal year 2011 (which begins in October 2010), and in the meantime Obama has proposed \$100 billion in tax cuts and government spending to create jobs. (Whether his proposals are the right way to spend \$100 billion is a debate for another time.)

The midterm elections are looming already (note: do we have to be satisfied with a political system in which the legislature is preoccupied with upcoming elections half the time?), and the two big themes seem to be jobs and the deficit. With unemployment at levels not seen since the 1980s, it's obvious why jobs are on the political agenda. With the federal budget deficit at record (nominal) levels, it also seems obvious that the deficit should be on the agenda, but this is really an unfortunate artifact of our political system. A government deficit is the result of insufficient government saving, and a period of high unemployment is absolutely the worst time to increase government saving. The sensible solution would be to use the urgency we currently feel to put in place long-term fiscal solutions, but the political system can't handle that (see health care reform as Exhibit A). As a result, when deficits go up, we get lots of short-term politicking about the deficit—in Paul Krugman's words, the "march of the deficit peacocks."

On these two themes, the Democrats' message is that (a) they are fixing the economy (growth is back, they are doing something about jobs) and (b) they are serious about the deficit (bank tax, three-year freeze, health care reform, etc.). The Republicans' message is that (a) the Democrats have failed to fix the economy (unemployment is still high) and (b) the deficit is the Democrats' fault due to runaway government

spending. While I have been extremely critical of the Obama administration for its generous policies toward large banks, which I believe have increased the risks facing the financial system in the future, otherwise they have taken directionally the right steps as far as jobs are concerned. And when it comes to long-term deficits, the Senate health care reform bill—whose cost-cutting measures are based largely on proposals from the administration, particularly Peter Orszag—is perhaps the biggest deficit-reduction bill of all time.

The Republicans, by contrast, are using their status as the party out of power to spout all sorts of nonsense when it comes to the deficit. Representative Paul Ryan was quoted by the New York Times calling the budget “nothing more than a plan for more of the same — a very aggressive agenda of more government spending, more taxes, more deficits and more debt — with just a few cosmetic budget maneuvers to give the illusion of restraint.” To begin with, I can give him a pass for redundancy (“more deficits and more debt”), but complaining about “more taxes” and “more deficits” in the same sentence? Does Paul Ryan not know how a deficit is measured, or does he not know where government revenues come from? Logically speaking, it must be one or the other.

Speaking of taxes, how did we get into this deficit mess in the first place?

You’ve no doubt seen this chart from the Center on Budget and Policy Priorities or something similar before, but that doesn’t make it any less true. And what is it in the president’s proposed budget that the Republicans are aiming at? The plan to let the Bush tax cuts lapse for people making more than \$250,000 per year. In other words, the problem with the Obama budget is that the deficits are too high, and the solution is to cut taxes. Huh?

None of this is new, of course. Sam Stein pointed out the same issues in December. Yet since Ronald Reagan, a large proportion of the electorate has become wired to believe that deficits are always the product of excess government spending, so the facts bear repeating.

The fiscal situation is actually very simple. The budget was in surplus when President Clinton left office, although there was already the prospect of budget-busting Medicare deficits in the long-term future. The 2001 and 2003 Bush tax cuts and the unfunded Medicare prescription drug benefit created the large deficits of the Bush era. (The Iraq and Afghanistan wars didn’t help, but it’s not fair to blame those

entirely on the Republicans; plenty of Democrats went along.) Then the financial crisis and the resulting recession blew a huge hole in government tax revenues, creating the current spike in deficits; that spike was exacerbated by the stimulus package, which most but not all economists would consider a sensible response to a major recession. (According to an earlier analysis by David Leonhardt, the projected average fiscal balance for the years 2009-2012 has changed, since Clinton left office, from an \$846 surplus to a \$1,215 billion deficit. The biggest lumps are \$673 billion in Bush administration policies and \$664 billion in the costs of the financial crisis and recession, including bailout costs.)

Yet somehow the Republicans have tried—successfully!—to spin our current and projected deficits as the result of “more government spending,” putting the Democrats on the defensive. And unfortunately, the result is the Obama administration buying into the Republican attack line—that government spending must be reduced. How else to explain the three-year spending freeze, which is mainly symbolic and a little bit destructive? The bipartisan commission to reduce the deficit has a little more to recommend it, although I’m skeptical that it will achieve anything. The Republican position seems to be that the deficit commission is bad because—wait for it—it might increase taxes. Here’s what the *Wall Street Journal* has to say:

“Republican leaders are under pressure from conservatives not to cooperate, due to concerns that the commission would recommend tax increases.

“‘Look, I don’t think anybody in the country thinks we have a problem because we tax too little, I think the problem is we spend too much,’ Senate Minority Leader Mitch McConnell (R., Ky.) said on CNN’s ‘State of the Union’ on Sunday. ‘So, I like the commission idea, just as I said a few months ago. I think a better way to do it is target spending.’

“Deficit hawks in both parties say the commission must be able to look at spending and revenue to make a dent in the deficit in the near term. But politically, its members could be boxed in. Not only are Republicans opposing tax increases, but they are also attacking Democrats for proposing cuts to Medicare.”

So, let’s recap. The medium-term deficit problem was created by Bush tax cuts and by an unfunded Bush-era expansion of Medicare. The long-term deficit problem is all about Medicare. Yet the only solution that

Republicans can think of is reducing spending—but not Medicare spending. Of course, this shouldn't surprise us; Mitch McConnell gave us this, after all.*

But apparently the sharp political minds in the Obama administration have decided that this is the turf they have to fight on. Now it seems that instead of going back to Bill Clinton in 1995-1996, they are reaching all the way back to 1993, when Clinton, Rubin, et al. decided to kill the deficit monster first and worry about helping the poor and the middle class later. They did kill the deficit monster (OK, they just knocked it out for a decade), but then they lost Congress in 1994 and never got around to helping the poor and the middle class; by the time we got a president and Congress who might have tried, it became time to kill the deficit monster again.

The real solution to the deficit problem must fix the long-term Medicare problem. That means some combination of reducing the long-term cost of health care (which the administration tried mightily to do, so far unsuccessfully) and increasing funding (taxes). The idea that we can just spend less money on health care costs as health care costs increase (and with about 47 million Americans already uninsured) is patently ridiculous—unless your goal is simply to let low- and middle-income seniors die. So the only important question is how to reduce Medicare spending or increase Medicare revenues. But with an opposition party ready to roll out its artillery at any mention of either Medicare cuts or tax increases, it's hard to see where a solution can come from.

* The image is from congressional Democrats, but the press releases were really issued by McConnell.

By James Kwak

Tom Hoenig For Treasury

Simon Johnson | 02 Feb 2010

The White House is floating, ever so gently, the notion that they are open to nominations for the position of “Tim Geithner’s Successor.”

It’s not clear if they mean this job is likely to be advertised formally sometime in 2012 or 20 minutes after the November midterms. Nor is it obvious if this is a real request for proposals – it could be just an effort to make critics “put up or shut up.”

Fortunately, there is an entirely plausible successor already in waiting, ready now or whenever the president finally realizes the need to fundamentally change banking policy.

Tom Hoenig, president of the Kansas City Fed, is best known for three things.

1. He’s currently the only senior Fed official who has been outspoken (or even spoken out) against banks that are undoubtedly Too Big To Fail (TBTF). Hoenig has been a beacon of clarity on this issue over the past year. Compared with central bank officials – and almost everyone else – Hoenig stands out as a model of straight thinking and a proponent of tough action. With his disarming but no nonsense approach, he is the perfect person to take on the likes of Lloyd Blankfein (Goldman Sachs) and Vikram Pandit (Citigroup) both in the corridors of power and in the nitty gritty of their rather sordid business models. Hoenig is a career bank supervisor and nobody’s fool. Blankfein and Pandit are just two more guys who run banks that have gone bad. You know how that movie ends.
2. Hoenig, who sits on the Federal Open Market Committee, is also an inflation hawk – at least by today’s standards. This makes some would be supporters – including fans of his attitude on TBTF – rather wary of advancing his name (e.g., as chairman of the Fed Board). This hesitation is understandable although likely mistaken; you don’t keep the federal funds rate essentially zero for long when nominal GDP is growing at more than a 6 percent annual rate. In any case, the issue is irrelevant for the Treasury job. The Treasury Secretary’s responsibility in a modern administration is to run financial sector policy, meaning bailouts and how to avoid them. Peter Orszag has the budget and Ben

Bernanke (gulp) holds the monetary tiller. What we desperately need is someone who can sort out our largest banks.

3. Tom Hoenig is almost certainly a Republican, although – as head of a regional reserve bank – the full range of his views, outside of banking and money, are not widely known. Paul Krugman reasonably points out that if he (Krugman) were nominated for the Fed (or Treasury or anything else), this would likely run into trouble in the Senate. Hoenig is a completely different kettle of fish, appealing to sensible Democrats and Republicans – yes, there are a few – who increasingly worry about massive banks and their electoral implications. And while financial sector policy is job one, serious efforts to address the budget – led by people of all ilk with a strong grip on economic realities – also lie in our future. Either that or the republic will perish. Not a tough choice in the end, but it does need to involve at least a few Republicans.

There will be objections to be sure.

- He's just a regional Fed governor. True, but so was Tim Geithner.
- He'll be captured by Big Finance, just as Geithner was. Spend some time with Tom Hoenig before you jump to this conclusion.
- The market will react negatively, because it will sense the era of unlimited bailouts is drawing to a close. Sure, but that's the point.
- He's a Republican. See point 3 above, and remember that President Obama offered Senator Judd Gregg (R., New Hampshire) the position of Commerce Secretary at the beginning of his administration.

There's also the question of whether Tom Hoenig would take the job. He doesn't seek it and no doubt doesn't need the hassle and the heartache.

So it would be a question of how he is asked and what powers he is given. With the right job description and enough protection from the very top, Hoenig is not the kind of person who shrinks from the opportunity to help his country back onto safer ground.

He's not a politician and he's not a banker. But he knows the politics of central banking and what bankers – of any size and kind – get up to.

Joe Kennedy, first head of the SEC, was by all accounts a poacher turned gamekeeper. Tim Geithner sees himself as a gamekeeper, but he is undone by the belief that the principal poachers are decent and honorable folk who mean no ill.

Tom Hoenig is just a plain spoken old-fashioned gamekeeper. Not many of them are left, but you only need one.

By Simon Johnson

Credit Card Cleverness

James Kwak | 02 Feb 2010

Most of the provisions of the Credit CARD Act of 2009 go into effect on February 22. Card issuers are adapting in various ways. I've previously written about the 79.9% APR (used to get around the limit on up-front fees for subprime cards). Now one of our readers has written in about an even more clever gimmick.

Here's the letter:

Section 171 of the CARD Act ([detailed guide here](#)) prohibits "hair-trigger" increases in credit card interest rates on outstanding balances, whereby an issuer could increase a rate for any reason at any time. 171(b) specifies how interest rates can be changed; for example, the rate can change as the index it is based on changes, or the rate can change at the end of a clearly defined introductory period. 171(b)(4) says that if a borrower misses a minimum payment, the issuer has to wait sixty days before raising the interest rate. 171(b)(4)(B) says that after raising the rate, if the borrower makes the minimum payments for the next six months, the issuer has to restore the previous rate.

The person who got the letter above used to have an 8.1% APR. This letter raises the APR to 29.99%. But, if he pays his balance on time, he will get a "credit" amounting to (at least) 70% of the interest amount, bringing the APR down to 8.99%. If he misses a minimum payment, he may not be eligible to continue in the program. In other words, he has an 8.99% APR that jumps to 29.99% *immediately* (retroactively, actually, since it can apply to the previous month's balance) if he misses a payment. Furthermore, the 8.99% rate does *not* have to be restored after six months of making payments, because the official rate was always 29.99%, and the 70% credit is just a "program."

This attempt to get around Congress's clear legislative intent is so transparent that it should be an easy case for the appropriate regulator to strike down. I believe the appropriate regulator for this kind of thing is the Federal Reserve. Maybe Ben Bernanke can show that he's serious about consumer protection.

By James Kwak

The Republican Plan, I: People Will Die

James Kwak | 03 Feb 2010

So the Republicans have a deficit reduction and a health care plan, all wrapped into one, the “Roadmap for America’s Future.” It’s being pushed by Paul Ryan, in part because he’s the ranking member of the House Budget Committee, in part because he’s good-looking and articulate, in part to provide the party plausible deniability if it flops (like Bobby Jindal a year ago). The CBO says that it will balance the budget and even eliminate the national debt by 2080. Ezra Klein and Matt Yglesias have commented on it. Klein says, “I wouldn’t balance the budget in anything like the way Ryan proposes. His solution works by making care less affordable for seniors. . . . But his proposal is among the few I’ve seen that’s willing to propose solutions in proportion to the problem.” Yglesias says “it’s totally unworkable.” But they’re both being much too kind.

Ryan realizes that “the deficit problem is a health-care problem,” which he agreed to in an interview with Klein. That’s good. He realizes that to solve the deficit you have to do something about Medicare. That’s good. He also puts forward a logically coherent conservative position. That’s good in itself and especially refreshing after the Bush era (and the unfunded Medicare prescription drug benefit) and all the recent posturing of the Republicans as defenders of Medicare (Mitch McConnell: “Cutting Medicare is not what Americans want.”) Ryan’s plan is basically to cut Medicare like never imagined before.

But everything else about the plan is such an unmitigated disaster I’m going to devote a whole paragraph at some point to thinking about how to label this plan. It will be a long time before we get there, though, broken into a couple of blog posts, because there are so many problems to go over.

This is the key picture, from the CBO opinion letter, which Klein also focused on:

The dark blue solid line is the current projection for Medicare. The dark blue dashed line is Medicare spending under the Roadmap. How does he do it? This will require a bit of context.

The problem with Medicare isn’t that Medicare is particularly generous (with its 20% copays, Medicare is worse than many of the PPOs working people get through their employers), or that it’s getting more generous. The problem is that per-person health care costs are growing

faster than government revenues, and to a lesser extent that the ratio of beneficiaries to workers is going up in the medium term. The Obama administration's approach to the Medicare problem is to try to reduce the growth of health care spending—"Cadillac tax," Independent Medicare Advisory Commission, experiments in pay-for-performance, cost effectiveness research, etc.—so that cost growth can be reduced while preserving the basic existing level of insurance. A reasonable argument against this plan is that we can't be sure that the cost reduction measures will work, so the government still bears the risk that the deficit will continue to grow. Fair point, but Peter Orszag would respond that they are trying almost everything that any sensible health economist has proposed.

The Roadmap takes the opposite approach: it puts all the risk of rising health care costs on beneficiaries. In concept, it takes the current amount that the government spends on Medicare and turns that into vouchers that are distributed to individual beneficiaries, who are then free to buy whatever health insurance they can in the free market.

The vouchers are designed to grow slower than equivalent insurance would cost

The trick is that the vouchers are indexed to "a blended rate of the CPI and the medical care component of the CPI." The plan is to have vouchers grow *slower* than health care cost inflation. According to the CBO (p. 21), vouchers would grow at an annual rate of 2.7% over the next seventy-five years, while Medicare spending would otherwise grow at an annual rate of 5.0%. (Those are actually nominal numbers; see page 10). This means that over about twenty-eight years, vouchers will double while the value of current Medicare would have quadrupled.

Let's use some real numbers. When the plan kicks in in 2021, vouchers will average \$11,000 per beneficiary (in 2010 dollars). (65-year-olds will only get \$5,900 vouchers; \$11,000 is the average across the Medicare population. More on that later.) According to the Census, 2008 median household income for households (where the householder is) over sixty-five was about \$30,000. Assume median household income grows at about 1% per year (in real terms). By 2021, when the shift starts, median income will be \$34,000 and an average two-person household will get \$22,000 in vouchers. Assume (and this is a huge assumption, on which more later) that the average household will be able to buy a policy as good as Medicare for \$22,000.

By 2049, median income will be \$50,000; the vouchers (growing at 0.7% in real terms, after subtracting 2 percentage points for inflation) will be \$29,000; and health insurance premiums (for equivalent coverage, assuming 3.0% annual growth) will be \$72,000. So after buying Medicare-equivalent coverage, the household will be left with \$7,000 for all other expenses. Under current law, by contrast, the household would have \$50,000 for all other expenses (since current Medicare is picked up by the government).

What will happen? People won't be able to afford coverage as good as Medicare is today. *People will die.*

The vouchers start out too small for equivalent coverage

Now, there is already one huge assumption built into the above: that, in 2021, \$22,000 in vouchers will buy you a family policy as good as Medicare would be. This assumption is patently false. Remember that 65-year-olds will start out with \$5,900 vouchers, so a household of two would get \$11,800 in vouchers. The average family plan bought through an employer today costs about \$13,000, and does not include anyone over the age of sixty-five (meaning that equivalent insurance for older people would cost more if there were a market for it). Furthermore, the \$5,900 number is being set today, and will grow from now until 2021 according to the Roadmap formula (average of the CPI and the CPI-M for medical costs)—which means it will be growing *slower* than health care inflation. So even before the shift begins in 2021, seniors will already be deep in the hole; even in 2021, the vouchers will not be able to buy equivalent coverage to Medicare. (On top of this, insurance will be provided by private insurers with higher administrative costs and less buying power than Medicare, meaning that beneficiaries will get even less bang for their buck.)

People get dumped into the individual market with no protection from medical underwriting

OK, what else is wrong here? For one thing, it dumps all seniors into the individual market. The Roadmap creates state-based insurance exchanges (like the Senate bill), which helps a bit. But it doesn't address the core problem: the ability of insurers to charge more to people who are sicker, even though it tries to make you think it does:

“Guaranteed Access to Care. The Exchange will require all participating insurers to offer coverage to any individual regardless of the patient's age or health history.

“Affordable Premium. Under the status quo, plans offering coverage to individuals often charge exorbitant premiums. This proposal solves the problem through independent risk-adjustment among insurance companies. A non-profit, independent board will penalize insurance companies that cherry-pick healthy patients while rewarding companies that seek patients with pre-existing conditions. This solution will ensure health insurers compete based on superior products and price.”

Do you see anything in there saying that insurers can’t set prices based on medical status? Risk adjustment is a valuable tool—*if you eliminate medical underwriting in the first place*. In that case, insurers “compete” by cherry-picking the healthy people. But if they can price based on medical status, they’ll just charge you whatever they think you will cost them in claims. If you need \$60,000 of chemotherapy and they charge you \$70,000 for your insurance policy, they get to keep all that money under risk adjustment, because you really are riskier. And chances are you can’t afford a \$70,000 insurance policy.

And here’s the entire section on “Protection for Those Who Need It Most”:

“Uninsured individuals with pre-existing health conditions have the most difficult time finding and affording health care coverage. As a result, many individuals with pre-existing conditions often face bankruptcy to pay for health care expenses or, worse, go without treatment. If these individuals are fortunate enough to have group health insurance, their high costs are spread among their coworkers and employers in the form of ever-higher premiums, making coverage expensive for all.

“Ensuring that “high-risk” individuals – those with the greatest medical costs – can obtain high-quality coverage is critical to the success of any plan to reform health care. High-risk individuals face an insurmountable burden in medical expenses themselves, and that burden is often transferred to taxpayers in the form of uncompensated care expenses from hospitals, or the placement of these individuals in Medicaid after having exhausted their financial resources paying for their medical costs.”

Do you see a proposal in there?

The only real backstop for sick people is this:

“Establishing High-Risk Pools. State health insurance high-risk pools will offer affordable coverage to individuals who would otherwise be denied coverage due to pre-existing medical conditions, making coverage affordable for those currently deemed ‘uninsurable.’ States may offer direct assistance with health insurance premiums and/or cost-sharing for low-income and/or high-cost families.”

This is like high-risk auto insurance pools: if you are such a bad driver that no insurer wants you, the state will give you insurance. This is better than nothing, but it’s a lousy solution. People end up in high risk pools because the actuarially fair cost of their insurance exceeds their ability to pay; if they could pay it, the free market could serve them. That means that the state ends up taking a loss on them. So the Roadmap’s solution for sick people is to dump them onto the states—who can decide if they want to let them live (which costs money from state budgets) or die.

The subsidies are insignificant

To recap so far: Median seniors won’t be able to buy Medicare-equivalent coverage when the shift begins. With every decade that passes, the problem gets much worse. Poor people are stuck in the individual market, which will dump them into state high-risk pools. People will die—unless the states step in to fill the gap, which basically means shifting the Medicare cost problem from the federal government onto the states.

The Roadmap does have some help for poor people. People below the poverty line can get about \$6,000 in a subsidy to cover out-of-pocket expenses through a medical savings account. People up to 150% of the poverty line get 75% of that subsidy. The problem is that the poverty line for a two-person household with the householder over 65 is \$13,030, and 150% of that is \$19,545. (By contrast, the Senate bill provides some amount of subsidy to families up to 400% of the poverty line.) But even if this threshold were raised, the subsidies are insignificant compared to the gaps that open up by 2049.

In short, the Roadmap balances the budget by slashing medical benefits to seniors far, far below where they are according to existing law. So far that most seniors will have to use up virtually all their income

if they want to buy Medicare-equivalent coverage. People will die. Unless, that is, health care costs can be brought down just as fast, which I'll address in my next post.

By James Kwak

The Republican Plan, II: You're On Your Own

James Kwak | 03 Feb 2010

In my [previous post](#) on the [Roadmap for America's Future](#), I discussed how the Republican plan is based on converting Medicare into a voucher program and then slashing the vouchers drastically relative to current Medicare spending projections, leaving seniors without the ability to buy anything close to what they get from Medicare today. In that post, I compared projected Medicare vouchers under the Roadmap to projected Medicare spending under current law. If you assume that, in the Roadmap world, the cost of Medicare-equivalent health insurance will be the same as currently projected Medicare spending, then people will die.

But, Paul Ryan would argue, the Roadmap is going to bring down the cost of health care, so the fact that we're providing less support won't matter. Put another way, he might say, Obama's plan also counts on bringing down the cost of health care, so why can't I make the same assumption? There are two problems with this argument.

The cost control measures are weak

The first is that the Roadmap simply doesn't do much to reduce health care costs. There's a lot of talk about things like electronic medical records, but basically it's just blather, as opposed to the detailed proposals in the Senate bill. The Roadmap pins cost reduction on one thing, and one thing only: eliminating the tax exclusion on employer-provided health care. I think this is a good idea, and I suspect that Peter Orszag does, too, but couldn't push it through for political reasons. But the idea that it's going to solve the health care cost problem alone is the kind of fantasy people have when they've only taken one semester of high-school economics and think the world works just like textbooks.

For one thing, the tax exclusion is just too small. The [median family household](#) had income of \$62,621 in 2008, which means it has a marginal tax rate of 15%. (We're pretty close to the 25% threshold, so I'll use 20% in what follows.) So without the exclusion, the typical family plan would cost about \$16,000 in pretax dollars, not \$13,000; the exclusion gives the median family a discount of 20%. Only about 60% of people get health insurance through an employer plan, so the average discount across the population is only 12%. Given that the price elasticity of health care is almost certainly a lot less than one (if you double the price, demand won't fall in half), the overconsumption due to the tax exclusion must be

less than 12%. Yet our per-capital health care expenditures are more than 60% above those of any other advanced country.

I know there are second-order effects blah blah blah, but I don't see how you can explain our entire health care cost problem as the result of one silly tax policy.

The Roadmap shifts all the risk from the government to households

More fundamentally, let's assume for a moment that the Roadmap contained a blueprint for health care cost reduction as detailed and likely to succeed as the Senate bill. What if they are wrong? Here we see the real difference between the Republicans and the Obama administration.

In the Democratic plan, if it turns out health care costs don't fall as fast as they hope, the deficits stay high and they try again. In the Republican plan, deficits fall and people die. In one case, the government budget bears the risk; in the other case, ordinary people bear the risk.

This gets at the fundamental question of what government is for, and maybe the fundamental difference between liberals and conservatives (at least those conservatives, like Paul Ryan, who are decent enough to have a coherent position). I believe that the government exists "for the people"—it exists to provide us things we can't provide for ourselves solely through a free market.

Social insurance is one of those things. People are risk averse. Between (a) a guaranteed \$40,000 per year in retirement and (b) a 50% chance of \$100,000 per year and a 50% chance of zero, most people would take (a). There are some kinds of insurance, like Medicare, that only the government can provide, because only the government has the fiscal credibility necessary. I know some of you are wondering how I can say "fiscal credibility," but do you think a twenty-two-year new college graduate can go to Aetna and buy a health insurance policy that will kick in when he turns sixty-five and pay out until he dies? No way. There is no way Aetna can take on that kind of risk.

This is why I wrote a post last summer entitled "You Do Not Have Health Insurance." Aetna can sell you a policy for one year, but they can't guarantee that you can have the same policy at a reasonable price next year. That's not what you want. You want the security of knowing that, for the rest of your life, you will be able to buy a decent health insurance policy for a reasonable price. There is no way a free market entity can provide a product like that. (Life insurance, by contrast, works because life expectancies are more predictable than future health care

costs—and besides, life insurance is generally backed by state-level government guarantees.)

The Republican platform is that people are better off on their own. The marketing behind this idea is impressive. Remember Bush's "ownership society," which meant that you "owned" your retirement? Given the choice between owning your retirement and having it guaranteed by someone else, why would you possibly choose the former? Yet that's the message.

The Roadmap is an extreme version of this ideology. The implicit premise is that we have to screw ordinary people—or at least make them bear a high degree of risk—in order to save the government budget. But what is the government budget? It's a pile of money that we contribute and that our representatives are supposed to spend on things we can't buy for ourselves individually. I know that those representatives make mistakes, are borderline corrupt, etc. But Medicare is exactly the kind of program that we want government to provide—a program that shifts risk from individuals to the government, and thereby the country as a whole—and that's why it's so popular, even with Mitch McConnell (on even-numbered days).

Gutting Medicare helps the federal deficit, but it does it by shifting the burden dollar-for-dollar onto individuals. Actually, it's worse than that, since Medicare does a better job of keeping administrative costs and reimbursement rates down than private health insurers. It's a net loss to the people as a whole, and that's what matters.

But . . . it's a net gain for the rich. Medicare is funded by a flat tax of 2.9% (unlike Social Security, there's no wage cap, so it's not actually regressive—well, it's somewhat regressive, since the tax is only on wage earnings, not investment income). So the amount you contribute is a percentage of your income. But the amount you get back is more or less the same for everyone. So effectively Medicare redistributes money from the rich to the poor. The Roadmap actually makes Medicare slightly more progressive, by reducing vouchers for people with high incomes. (For example, couples making over \$400,000 will only get 30% of the standard voucher; but that means their incomes are more than 8x the average and they get 1/3 the benefit.) But the big thing it does is drastically shrink the size of Medicare, so in 2040 it is 3.8% of GDP as opposed to 10.9% under current projections (CBO letter, page 6).

So the net effect is to take a redistributive program (that is the whole point of social insurance, after all—we don't know who will be rich at age

65, so we're willing to hedge our bets) and slash it to less than 40% of its projected size.

What would I do? I think that social insurance is good (because otherwise poor old people will die) and that people want it (because they are afraid of being poor and dying). Everyone agrees that we should do what we can to bring down health care costs in general and to make Medicare more efficient. But assuming for the moment that that isn't enough to prevent deficits from ballooning, I think we should increase the Medicare payroll tax (or, better yet, income taxes, which are progressive) to fill the gap. Paul Ryan and the Republicans think we should let people fend for themselves.

Remember, all the money we're talking about belongs to all of us. Either we tax ourselves, put it in a pool, and provide health insurance for all seniors; or we don't tax ourselves, put it in our wallets, and hope that we'll be among the lucky few rich enough to pay for health care when we retire. (I know there are efficiency arguments as well, but they break both ways, since Medicare itself is more efficient than private insurers; and in any case, because of risk aversion, we should be willing to give up some expected output in exchange for better security.)

That's the choice.

Update: Austin Frakt says that I estimated the impact of the tax exclusion incorrectly.

By James Kwak

The Republican Plan, III: Comic Relief

James Kwak | 03 Feb 2010

(This is a multi-post series on the Republicans' Roadmap for America's Future. Part I was on how it slashes Medicare spending. Part II was on how it shifts risk from the government to individuals.)

The Roadmap brings up the issue that there is little price transparency in the health care market. This is the solution:

"The environment resembles what existed in the securities markets before the stock market crash of 1929. Abuse, fraud, and misinformation about the nature of stocks and the rules governing their purchase were rampant. In response, the Securities and Exchange Commission [SEC] was formed with the main purpose of bringing transparency to the market and restoring consumer confidence.

"With the increasingly rapid transformation of the financial markets and the growing complexity of financial transactions, the private sector began to take a more prominent role in developing accounting guidelines; and eventually the SEC began relying on the private sector to establish the basic standards by which it would be regulated. Since 1973, the SEC has recognized the nongovernment Financial Accounting Standards Board [FASB] as the authoritative standard-setting organization for financial accounting and reporting information. While the SEC has statutory authority to establish such financial standards, it has historically adopted FASB rules. The SEC allows the private sector to establish its own disclosure standards, so long as it demonstrates the ability to fulfill the responsibility in the public interest. The authority to enforce the standards, however, falls solely to the SEC.

"Applying this model to the health care industry will allow all stakeholders to come together, without heavy-handed government intervention, to establish uniform and reliable measures by which to report quality and price information."

Enron? WorldCom? Self-regulation? FASB, the SEC, and the *securities* industry are their example?

By James Kwak

Kevin Warsh: “No Firm Should Be Too Big To Fail”

Simon Johnson | 04 Feb 2010

The debate over Ben Bernanke’s reappointment, and his approach to the financial system, may after all have had some impact. In a speech yesterday, Kevin Warsh – the Federal Reserve Board Governor who liaises between Ben Bernanke and financial markets – signaled a major change in Fed thinking regarding “too big to fail”.

Warsh was much blunter than we have heard from the Fed in a long while: “Moral hazard in the financial system is higher than any of us should countenance”; “eradicating the too-big-to-fail problem should be the predominant policy goal”; and “in the new regime, no firm should be too big to fail.”

At some level, Warsh and his colleagues are finally learning the main lesson of 2008-09.

“We need a system in which insolvent firms fail. Market discipline only works if governments can demonstrably and credibly commit to allow firms to fail. This system isn’t just about giving government officials better options on Sunday nights. It is about making sure that market discipline is operative in the prior months and years to avoid altogether the proverbial Sunday night judgments.”

But there is still a major problem in the Fed’s thinking.

Warsh is right that market dynamics could be helpful.

“Market entry and market exit can be a more effective means of developing a stronger, more resilient financial system. The too-big-to-fail problem could be mitigated if smaller, dynamic firms seized market share from less nimble incumbents”

And he is completely on target with the respect to the principle at stake.

“Competition is undermined when a privileged class of financial firms has the implicit support of the government. No firm ought to be entitled to favored consideration by regulators or government policy. No rating agency. No mortgage finance entity. No dealer or underwriter. And no bank. The tempting top-

down approach to level the playing field is to bully or co-opt our largest, most interconnected firms. In my view, however, robust competition from the bottom-up is the better way forward.”

But he stops short of calling for a restriction on the size of our largest banks. Without that, it is very hard to see how his competitive mechanisms will work.

The current low relative cost of credit for mega-banks – significantly below what is paid by smaller banks that can fail (i.e., banks that can realistically be taken over through a FDIC intervention) – constitutes a form of unfair subsidy that enables the biggest banks to become even larger.

How exactly does Mr. Warsh plan to back away from this situation? He implies we should promise not to help huge banks when they get into trouble – but surely he knows this would not be credible.

He also makes some vague statement about helping smaller banks, but how does that work when the big banks now dominate the markets at the center of our financial system?

While the US financial system has a long tradition of functioning well with a relatively large number of banks and other intermediaries, in recent years it has become transformed – through years of regulatory and antitrust neglect – into a highly concentrated system for key products. 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 over-the-counter derivatives. Three U.S. banks have over 40% of the global market for stock underwriting. This degree of market power is dangerous in many ways.

As Mr. Warsh now realizes, these large banks are widely perceived – including by their own management, creditors, and government officials – as too big to fail. The executives who run these banks obviously have an obligation to make money for their shareholders. The best way to do this is to take risks that pay off when times are good and that result in bailouts – creating huge costs for taxpayers and all citizens – when times are bad.

This incentive system distorts market outcomes, encourages reckless risk-taking, and will lead to serious trouble. While reducing bank size is not a panacea and should be combined with other key measures that are not yet on the table – including a big increase in capital requirements –

finding ways to effectively reduce and then limit the size of our largest banks is a necessary condition for a safer financial system.

The Fed is apparently, at last, moving the right direction on the issue of “too big to fail”. But how long will it take to get there?

By Simon Johnson

Taxes

James Kwak | 04 Feb 2010

But, I hear you saying (and emailing) after my last few posts, higher taxes are bad for the economy because people don't work as hard, making the pie smaller for everyone.

Yes, that's what it says in the textbook. But the issue is more complicated than that. Look at this, for example:

What do you see? Nothing? That's what I see, too. Of course, the topic is more complicated than a single picture. (For starters, I'd like to replace the top marginal tax rate with the marginal tax rate for people making, say, 3x the national average and see what that looks like—anyone know where I can find that data?) I'm sure that people have done sophisticated analyses of this question controlling for this, that, and the other thing, and I'm also sure you can find studies on both sides of the question.

Then there's the idea that high taxes and the nanny state cause people to work less hard, preferring unemployment to an honest day's work. If you believe that, I recommend this picture to you:

Again, I don't think these pictures prove anything. Well, maybe they prove one thing: that the real world is more complicated than the first-year economics textbook. Maybe higher taxes do result in less effort and less growth when you control for everything else. On the other hand, maybe lower taxes and the resulting higher inequality result in a larger amount of what Sam Bowles calls "guard labor"—people whose job is to keep the poor part of the labor force in line, which is all basically unproductive.

If there's one thing I'd like people to take away, it's that any theoretical economic argument that can be stated in a sentence is as likely to be untrue as true in the real world, no matter how clever or intuitive it is.

By James Kwak

Remember Those Stress Tests?

James Kwak | 04 Feb 2010

I'm curious to know how banks' 2009 final results compare to the projections in the stress tests. My suspicion is that JPMorgan and Goldman did better than projected, but Citi may have done worse. Ideally you would compare both the new loan losses recognized over the year and the profits from current operations. But there are a couple of problems with doing this. One is that the stress test results were for 2009-2010 combined, without the separate years split out. The other problem is that it's not immediately obvious how to map the line items from the stress test results to the line items on a bank's income statement (or to changes on its balance sheet). I might be able to figure it out with a lot of study, but I might not.

Does anyone know of someone who has already done an analysis along these lines? Or does anyone know how to do the mapping correctly?

By James Kwak

Goldman Sachs And The Republicans

Simon Johnson | 05 Feb 2010

I testified yesterday to the Senate Banking Committee hearing on the “Volcker Rules” ([full pdf version](#); [summary](#)). My view is that while the principles behind these proposed rules are exactly on target – limiting the size of our largest banks and preventing any financial institution backed by the government, implicitly or explicitly, from taking big risks – the specific rule changes would need to be much tougher if they are to have any effect.

Wall Street is strongly opposed to the Volcker Rules ([link to the written testimony](#); [webcast](#)) and the discussion elicited some classic Goldman Sachs moments. [Gerry Corrigan](#), a senior executive at Goldman and former head of the New York Fed, suggested that Goldman Sachs has an impeccable approach to risk management and seemed to imply that the firm was not in trouble in fall 2008. When pressed on why Goldman requested and was granted a banking license – and access to the Fed’s discount window – in September 2008, [he fell back](#) slightly, “There is no question whatsoever that when you look at totality of the steps that were taken by central banks and government, particularly in 2008, that Goldman Sachs was a beneficiary of this.”

The [public record is clear](#) – Goldman Sachs would have failed in September 2008, were it not for the support provided by the government. The fact that some of this support did not involve direct use of taxpayer money speaks to the ingenuity of the people involved, but it should not distract us from the substance. Goldman Sachs was failing and it was saved.

Why is this so hard for Goldman to admit?

Goldman Sachs was too big to fail in fall 2008, with assets over \$1 trillion. It is still too big to fail, with assets closer to \$800 billion. Everyone now says that “too big to fail” is a terrible problem and must be addressed.

But none of the ideas currently on the legislative table would have any real effect – in the sense that next time you will be able to let Goldman fail.

- The Republicans (and Goldman Sachs) want a “resolution authority” that would give the government greater power to take big banks through bankruptcy. But even assuming there were sufficient political will to use such power, as Mr Corrigan and

John Reed conceded at yesterday's hearing, because this would be only US-centric (and there is no prospect of a G20 or other international agreement anytime soon) it simply would not work for huge cross-border firms. When such a firm fails – and Mr Corrigan made a point of emphasizing that half of Goldman's meteoric growth since 1997 has been "global" – a resolution authority will do you no good at all.

- The Federal Reserve leans towards "stronger regulation". But every regulator sent to control big banks over the past 30 years has ended up completely captured – most recently the people who allowed Goldman to keep its bank license while retaining its full range of risky activities. You can add to the powers of the Fed or take them away completely but this will not change.
- The administration prefers a bipartisan approach – avoiding confrontation on the true nature of "too big to fail" or even explaining how much worse our problems became during the Bush years – but that just can't work when the other side refuses to cooperate. Given Republican relationships with big banks, there will be no serious attempt to cut financial institutions down to a size at which they could be allowed to fail – no meaningful version of the Volcker Rules will make it into law.

Goldman and the other big Wall Street firms have already won big on this round. They will plow even more money into defeating political candidates who have opposed them – for example, on credit card legislation. The Republicans see this coming and are rubbing their hands with glee.

With their incentive structure intact – they get the upside and regular folk get the downside – and their closest friends on their way back to power, Big Finance is ready to roll into the next great global boom-bust cycle.

By Simon Johnson

The Economist Backs Cantwell-Collins

James Kwak | 05 Feb 2010

Which, attentive readers know, is the climate change bill that auctions almost all emission allocations starting on day one, and refunds most of the proceeds to households. Here's the *Economist* story. (Technically, it's just the columnist "Lexington," but the *Economist* has a consistency voice and position unlike any other news publication.) Here's an excerpt:

"Of all the bills that would put a price on carbon, cap-and-dividend seems the most promising. . . . The most attractive thing about the bill is that it is honest. To discourage the use of dirty energy, it says, it has to be more expensive. To make up for that, here's a thousand bucks.

"This challenges the conventional wisdom in Washington, DC, that the only way to pass a global-warming bill is to disguise what's in it. Leading Democrats try to sell cap-and-trade as a way to create jobs and wean America from its addiction to foreign oil."

The standard argument against cap-and-trade, or cap-and-dividend, or doing anything about climate change, is that it will cost money. This is true, although the amount is a lot less than people tend to believe. (According to the CBO, Waxman-Markey would have a "net economywide cost" of \$22 billion in 2020, or \$175 per household [Table 1, PDF page 15]; the CBO does not attempt to quantify any benefits from slowing down global warming.) Compared to Waxman-Markey, Cantwell-Collins is a simple way to deal with the problem with relatively little micromanagement (CC is 1/36th the length of WM, according to the *Economist*) and less politicization of initial allocations.

Cantwell-Collins *should be* the solution preferred by advocates of the free market. Waxman-Markey was crafted to satisfy coal-state Democrats in order to get what is basically a Democratic majority in the House, but whether that can make it through the Senate is a big question. By contrast, Cantwell-Collins should be able to create a coalition behind it that includes non-coal-state Democrats and moderate Republicans who want to do something about climate change. (Note that most large corporations—which once upon a time were the core of the Republican Party—want climate change regulation, because they want regulatory

certainty.) It will be opposed by coal-state Democrats and by climate change deniers, of course.

But this depends on those “moderate Republicans” deciding to vote for a real solution as opposed to voting against it simply to prevent the Obama administration and Democratic majority from accomplishing anything. I would bet on the latter.

By James Kwak

Is Tim Geithner Paying Attention To the Global Economy?

Simon Johnson | 06 Feb 2010

In an interview that will air Sunday on ABC, Treasury Secretary Tim Geithner says, ““We have much, much lower risk of [a double-dip recession] today than at any time over the last 12 months or so ... We are in an economy that was growing at the rate of almost 6 percent of GDP in the fourth quarter of last year. The most rapid rate in six years. So we are beginning the process of healing.”

The timing of this statement is remarkable because, while the US is finally showing some signs of recovery, the global economy is bracing for another major shock – this time coming from the European Union.

The mounting debt and deficit problems in Greece might seem relatively small and faraway to the US Treasury – concerned as it is with China’s exchange rate and the ritual of G7 meetings, and likely distracted by the major snow storm now hitting Washington DC.

But the problems now spreading from Greece to Spain, Portugal, Ireland and even Italy portend serious trouble ahead for the US in the second half of this year – particularly because our banks remain in such weak shape.

Greece is a member of the eurozone, the elite club of European nations that share the euro and are supposed to maintain strong enough economic policies. Greece does not control its own currency – this is in the hands of the European Central Bank in Frankfurt. In good times over the past decade, this helped keep Greek interest rates low and growth relatively strong.

But under the economic pressures of the past year, the Greek government budget has slipped into ever greater deficit and investors have increasingly become uncomfortable about the possibility of future default. This impending doom was postponed for a while by the ability of banks – mostly Greek – to use these bonds as collateral for loans from the European Central Bank (so-called “repos”).

But from the end of this year, the ECB will no longer accept bonds rated below A by major ratings agencies – and Greek government debt no longer falls into this category. The market can do this kind of math in about 20 seconds: If the ECB won’t, indirectly, lend to the Greek government, then interest rates will go up in the future; in anticipation of this, interest rates should go up now.

That is trouble enough for an economy like Greece – or any of the weaker eurozone countries that have been known, for some time and not in an endearing way as the “PIIGS”. But paying higher interest rates on government debt also implies a worsening of the budget; this is exactly the sort of debt dynamics that used to get countries like Brazil into big trouble.

The right approach would be to promise credible budget tightening down the road and to obtain sufficient resources – from within the eurozone (the IMF is irrelevant in the case of such a currency union) – to tide the country over in the interim.

But the Germans have decided to play hardball with their weaker and – it must be said – somewhat annoying neighbors. As we entered the weekend, markets rallied on the expectation that there might be a bailout for Greece (and all the others under pressure). But, honestly, this seems unlikely. The Germans hate bailouts – unless it’s their own banks and auto companies on the line. And the Europeans policy elite loves rules; in this kind of situation, their political process will grind on at a late 20th century pace.

In contrast, markets now move at a 21st century global network pace. This is a full-scale speculative attack on sovereign credits in the eurozone. Brought on by weak fundamentals – it’s the budget deficit, stupid – such attacks take on a life of their own. Remember the spread of pressure from Thailand to Malaysia and Indonesia, and then the big jump to Korea all in the space of two months during fall 1997.

Tim Geithner and the White House may feel they must stand aloof, waiting for the Europeans to get their act together. This is a mistake – the need for US leadership has never been greater, particularly as our banks are really not in good enough shape to withstand a major international adverse event (e.g., Greece defaults, Greece leaves the eurozone, Germany leaves the eurozone, etc).

Yes, we subjected our banks to a stress test in spring 2009 – but the stress scenario was mild and more appropriate as a baseline. Many of our banks – big, medium, and small – simply do not have enough capital to withstand further serious losses (think commercial real estate).

As the international situation deteriorates – or even if it remains at this level of volatility – banks will hunker down and credit conditions will tighten around the US.

And if the European situation spins seriously out of control, as it may well do early next week, the likelihood of a double-dip recession (or significant slowdown in the second half of 2010) increases dramatically.

By Peter Boone and Simon Johnson

Europe Risks Another Global Depression

Simon Johnson | 07 Feb 2010

The entirely pointless G7 meeting this weekend only served to underline the fact that Europe is again entering a serious economic crisis.

At the end of the meeting yesterday, Treasury Secretary Tim Geithner told reporters, “I just want to underscore they made it clear to us, they the European authorities, that they will manage this [the Greek debt crisis] with great care.”

But the Europeans are not being careful – and it’s not just about Greece any more. Worries about government debt and associated public sector liabilities (e.g., because banking systems are in deep trouble) have spread through the eurozone to Spain and Portugal. Ireland and Italy are next up for hostile reconsideration by the markets, and the UK may not be far behind.

What are the stronger European countries, specifically Germany and France, doing to contain the self-fulfilling fear that weaker eurozone countries may not be able to pay their debt – this panic that pushes up interest rates and makes it harder for beleaguered governments to actually pay?

The Europeans with deep-pockets are doing nothing – except insist that all countries under pressure cut their budgets quickly and in ways that are probably politically infeasible. This kind of precipitate fiscal austerity contributed directly to the onset of the Great Depression in the 1930s.

The International Monetary Fund was created after World War II specifically to prevent such a situation from recurring. The Fund is supposed to lend to countries in trouble, to cushion the blow of crisis. The idea is not to prevent necessary adjustments – for example, in the form of budget deficit reduction – but to spread those out over time, to restore confidence, and to serve as an external seal of approval on a government’s credibility.

Dominique Strauss-Khan, the Managing Director of the IMF, said Thursday on French radio that the Fund stands ready to help Greece. But he knows this is wishful thinking.

- “Going to the IMF” brings with it a great deal of stigma. European governments are unwilling to take such a step as it could well be their last.

- The IMF is supposed to provide only “balance of payments” lending. That doesn’t fit well when a country is in a currency union such as the euro, which floats freely and does not have a current account issue, and the main problem is just the budget.
- Greece and the other weak eurozone countries need euro loans, not any other currency. If the IMF lent euros, that would be distinctly awkward – as this is what the European Central Bank (ECB) is supposed to control.
- Sending Greece to the IMF would result in some international “burden sharing,” as it would be IMF resources – from all its member countries around the world – on the line, rather than just European Union funds. But is the US really willing to burden share through the IMF? After all, Europe has long refused to confront the trouble in its weaker countries, now known as PIIGS (Portugal, Ireland, Italy, Greece, and Spain)? How would the Chinese react if such a proposition came to the IMF?
- Would the Europeans really want the IMF and its somewhat cumbersome rules to get involved – this would be a huge loss of prestige. It could also lead to some perverse outcomes – you never know what the IMF and the US Treasury (and Larry Summers) will come up with in terms of needed policies (ask Korea about 1997-98; not a good experience). The European Union (EU) has handled IMF recent engagement well in eastern Europe (from the EU perspective), but that was seen as the EU’s backyard. If the eurozone is in trouble, everyone will be paying much more attention – no more sweetheart deals.
- The IMF gave eastern Europe amazingly good deals over the past 2 years (by IMF standards). Would this fly with financial markets in the sense of restoring confidence in the PIIGS and their medium-term fiscal futures?
- Does the IMF really have enough resources to backstop all the PIIGS? The IMF’s notional capital was increased substantially last year, but just based on what we see now, the Fund would need even more ready money to tackle the eurozone – all the weaker countries would need at least preventive lending programs and these would need to be large. If that is where this goes, the EU looks simply awful and has failed at a deep level.
- The IMF could play a constructive “technical assistance role” alongside the European Commission, but everyone would want to keep this pretty low profile. Anything that goes to the IMF

executive board would result in a lot of cheering and jeering from emerging markets. This would break the power of Europe on the international stage – perhaps a good thing, but not at all what the European policy elite is looking for.

The IMF cannot help in any meaningful way. And the stronger EU countries are not willing to help – in part because they want to be tough, but also because they do not have effective mechanisms for providing assistance-with-strings. Unconditional bailouts are simple – just send a check. Structuring a rescue package that will garner support among the German electorate – whose current and future taxes will be on the line – is considerably more complicated.

The financial markets know all this and last week sharpened their swords. As we move into this week, expect more selling pressure across a wide range of European assets.

As this pressure mounts, we'll see cracks appear also in the private sector. Significant banks and large hedge funds have been selling insurance against default by European sovereigns. As countries lose creditworthiness – and, under sufficient pressure, very few government credit ratings will hold up – these financial institutions will need to come up with cash to post increasing amounts of collateral against their derivative obligations (yes, the same credit default swaps that triggered the collapse last time).

Remember that none of the opaqueness of the credit default swap market has been addressed since the crisis of September 2008. And generalized counter-party risk – the fear that your insurer will fail and this will bring down all connected banks – raises its ugly head again.

In such a situation, investors scramble for the safest assets available – “cash”, which actually (and ironically, given our budget woes) means short-term US government securities. It's not that the US is in good shape or even has anything approaching a credible medium-term fiscal framework, it's just that everyone else is in much worse shape.

Another Lehman/AIG-type situation lurks somewhere on the European continent, and again our purported G7 (or even G20) leaders are slow to see the risk. And this time, given that they already used almost all their fiscal bullets, it will be considerably more difficult for governments to respond effectively when they do wake up.

By Simon Johnson

Euro Falling, US Recovery Under Threat

Simon Johnson | 08 Feb 2010

Intensified fears over government debt in the eurozone are pushing the euro weaker against the dollar. The G7 achieved nothing over the weekend, the IMF is stuck on the sidelines, and the Europeans are sitting on their hands at least until a summit on Thursday. There is a lot of trading time between now and then – and most of it is likely to be spent weakening the euro further.

The UK also faces serious pressure, and there is no telling where this goes next around the world – or how it gets there.

There may be direct effects on the US, as our banking system remains undercapitalized. Or the effect may be through making it harder to export – one of the few bright spots for the American economy over the past 12 months has been trade. But this is unlikely to hold up as a driver of growth if the euro depreciation continues.

Some financial market participants cling to the hope that the stronger eurozone countries, particularly Germany, will soon help out the weaker countries in a generous manner. But this view completely misreads the situation.

The German authorities are happy to have the euro depreciate this far, and probably would not mind if it moves another 10-20 percent. They are convinced that they must – in fact, should – export their way back to acceptable growth levels.

Competitive depreciation is of course a no-no in international policy circles. But if your dissolute neighbors – with whom you happen to share a credit union – threaten to implode their debt rollovers, and markets react negatively, how can you be held responsible?

Germany and France have no objection to euro depreciation – they are confident that the European Central Bank can prevent this from turning into inflation.

It's the US that should be concerned about the effect on its exports (and imports; goods from the eurozone become cheaper as the euro falls in value) if the euro moves too far and too fast. But the US failed to raise the issue with sufficient force at the G7 finance ministers conclave in Canada and the course is now set – at least until Thursday.

The euro depreciates, the dollar strengthens, and our path to recovery starts to run more uphill.

And if these European troubles start to be reflected in difficulties for leading global banks over the next few days or weeks, the negative impact will be much greater.

By Simon Johnson

Fed Chair as Confidence Man

James Kwak | 08 Feb 2010

I'm not the one saying it—that would be Robert Samuelson, columnist for Newsweek and the Washington Post. The sole point of Samuelson's recent opinion piece is that Ben Bernanke's job is to increase confidence.

Like much but not all error, there is a grain of truth to this point. Thanks to John Maynard Keynes (whom Samuelson cites), George Akerlof, Robert Shiller, and any number of economics experiments, we know that confidence has an effect on behavior and hence on the economy. Too much overconfidence can fuel a bubble and too much pessimism can exacerbate a slowdown.

But to leap from there to the conclusion that the job of the chair of the Federal Reserve is to increase confidence—"Ben Bernanke has, or ought to have, a very simple agenda: improve confidence"—is just silly.

The Federal Reserve has two important jobs: (1) set monetary policy and (2) regulate bank holding companies and enforce financial consumer protection statutes. These affect the real economy in very concrete ways, not just via their impact on confidence. Saying that the objective of bank regulation should be to improve confidence is not just silly, it's destructive. If your goal were to improve confidence, you would never restrict predatory lending practices (since they are good for banks and for asset prices) or crack down on undercapitalized banks (since that would reduce confidence in the banking system). I would submit that the first item on Ben Bernanke's agenda should be doing the job mandated by Congress.

Equally quarter-baked is the idea that Bernanke should go out and talk up the economy. Even if we agree that too much or too little confidence can be a bad thing, how do we know that the current level of confidence is too low? Samuelson says that 47% of Americans rated the economy as "poor" in mid-January—with unemployment at 10% (now 9.7%), I'd say that seems low if anything. Is it really a good thing for people to be more optimistic than the economic fundamentals warrant? That's not a rhetorical question—think back over the past decade.

If Samuelson's point is that Bernanke should do a good job because that will make people feel more confident in the Federal Reserve, then that's virtually a tautology, and certainly not worth writing eight hundred words about. If his point is that Bernanke should seek to

improve confidence as an independent objective (implied by everything in the article itself), then that's nutty.

Then there are the additional bits of silliness, like this one: "The administration's decision to push health-care legislation was a blunder. It sowed conflict and was so time-consuming that it paralyzed action on other issues. Business planning and the willingness to expand have suffered, because companies find it harder to predict their costs and returns." Businesses are one of the major interest groups supporting health care reform, because they bear the brunt of increasing health care costs, and they face the tough choice every year between increasing their personnel costs and cutting back on health care benefits. Most companies would like nothing better than the development of a viable alternative to the employer-based health care system. And what data could possibly exist that would back up the assertion that businesses have expanded slower *because of* health care reform, as opposed to, say, reduced availability of credit?

But I've already given Samuelson's column more time than it's worth.

By James Kwak

Whose Fault?

James Kwak | 08 Feb 2010

To believe politicians in Washington and pundits in the media, the national debt has become the most important political issue of the day. (Whether it should be—as opposed to, say, jobs—is another question.) The Republican argument is, basically: “Big deficits! Democratic president! His fault!” The Obama administration argument, by contrast, is “No way! George W. Bush’s fault!”

I generally side with Obama on this one, mainly because of the two Bush tax cuts and the unfunded Medicare prescription drug benefit. Keith Hennessey, Bush’s last director of the National Economic Council, has a counterargument. Some of his points are good. OK, well, one point—the fourth one down. Hennessey is right that what initially transformed the Clinton surplus into the Bush deficit was the 2001 recession, which was beyond Bush’s control—just like what transformed the large Bush deficits of 2007-2008 into the enormous Obama deficits of today was the 2007-2009 recession.

The other points are good debating, but I don’t buy them. This could take a while.

1. Obama: Unfunded Medicare prescription drug benefit? Hennessey: Why don’t you repeal it instead of complaining about it? You could even use reconciliation.

OK, if Obama were king. Hennessey admits that his administration created a mess and says Obama should clean it up. But cleaning up the mess means either reducing entitlements or increasing taxes, would be incredibly unpopular, and would obviously be filibustered by the Republicans, the new Defenders of Medicare. There’s no way Obama could get 51 Democrats with him on this, and if he could, it would mean an end to Democratic majorities in Congress and to Obama’s hopes for re-election. I believe there are times when you should take a political hit to do the right thing (because the point of a majority is to govern, not to extend your majority), but asking the Democrats to commit political suicide to repair a Bush-era mistake is a bit rich.

2. Obama: Unfunded wars in Iraq and Afghanistan! Hennessey: Get out, then.

In this case, the Bush administration began a war in Iraq on false (or at least wrong) pretenses and made that country much more dangerous, while neglecting the war in Afghanistan. Obama opposed the Iraq

War—that's a major reason why he's president today instead of Hillary Clinton. But he can't simply say that the last six years never happened and pull out immediately. Colin Powell was right (even if he was wrong about Pottery Barn's policy): "You break it, you own it." And if he did pull out, the Republicans would crucify him politically. National security issues, like entitlements, only go one way politically—it's much easier to be a hawk than a dove when it comes to fighting wars in the Middle East.

3. Obama: Tax cuts! Hennessey: Let them lapse, then.

See 1 and 2 above. Republicans are already positioning letting tax cuts lapse on the super-rich as "tax increases." It's a lot easier as a politician to give away candy than to take it back. The Republicans have cleverly played the game of enacting policies when in power that are politically difficult to repeal. (Note: The Democrats are trying the same thing with health care reform.) The goal is to force the government to shrink via spending cuts.

Hennessey also says that bracket creep will cause taxes as a percentage of GDP to climb above the long-term average. But it's natural and good for taxes to climb upward as a society becomes wealthier, because the government does more. Entitlements go up as people's conception of what an adequate minimum living standard is. Regulatory costs go up as businesses and products become more complex. Defense costs go up as the amount we are willing to invest in minimizing the risk of death to soldiers goes up. That's a *good* thing.

Hennessey also says that the long-term problem is Medicare and Social Security. He's right (about Medicare, at least). But then he says that therefore the tax cuts don't matter. This is clever misdirection, since the political issue is why the deficits are so big today—and they are big today, in large part, because of the Bush tax cuts.

5. (Remember, I agreed with 4.) Obama: I inherited a \$1.3 trillion deficit! Hennessey: Yes, but that was due to the recession. And then you passed an expensive stimulus package.

Hennessey's first point is unobjectionable. But insofar as the argument is over why we have big deficits today, it's also irrelevant. The trillion-dollar deficits we have today are the result of pre-Obama policies, just like the initial descent into deficit under Bush was due to pre-Bush policies.

His second point is just silly. In the face of a collapsing economy, the right thing is a stimulus package. The insistence in budgetary balance at

the beginning of the 1930s is one of the most cited causes of the Great Depression (along with tight monetary policy and the gold standard).

6. Obama: When I took office, there were already \$8 trillion in projected deficits. Hennessey: You changed the rules—it was only \$3 trillion. “The President’s first budget played games by redefining the baseline to make the starting point look as bad as possible so that Team Obama could claim their policies would reduce the deficit.”

Well, we might never agree here, but I would say that Team Obama reversed out the games that the Bush administration (and previous administrations) had been playing all along. According to The New York Times, the “gaming” that Hennessey accuses Obama of is this:

- Ending the Bush practice of keeping Iraq and Afghanistan out of the budget and using supplemental appropriations instead.
- Assuming that AMT will be patched by Congress each year (as it is), rather than pretending that it will be allowed to encompass the middle class.
- Ending the Bush practice of budgeting artificially low Medicare payments and then allowing higher payments during the year.
- Adding a budgetary line for disaster relief; historically the government paid for disaster relief, but never budgeted for it.

Secondly, Hennessey’s charge doesn’t make logical sense. Changing the rules would only help Obama claim to reduce the deficit in the future if he were planning to change the rules back in the future. Unless Hennessey thinks Obama had a secret plan to stop assuming AMT fixes at some point in the future (or something similar), his argument not only isn’t true, it can’t possibly be true.

Hennessey’s major point is to say that Obama should stop playing the “blame game” (defined, in Washington, as someone else pointing out something you did wrong):

“I suspect that many Americans are tired of the blame game, especially more than one year into a new Administration. Whatever your view of President Bush, his policies, and their results, America needs to look forward. We have big challenges ahead of us, and we need to propose, debate, vote on, and then implement solutions.”

I agree that blaming everything on George W. Bush is neither good policy nor good politics. But there are some issues on which it is not only

relevant, it is necessary to point out why we are in the mess we are in. One is tax cuts. The Republican attack line is “Tax increases bad. Hurt economy.” Now, the empirical evidence for that is weak. But more important, pointing out that you just want to repeal the Bush tax cuts means that we are going back to the marginal tax rates of the Clinton years, when the economy was booming. This is different from raising taxes to a level that the economy has not seen before—that might be risky. Simply undoing a policy is politically and substantively different from putting in place a new one.

Similarly, when people attack you for increasing government spending, it makes perfect sense to point out that they voted for the unfunded Medicare prescription drug benefit, because it is relevant whether they are deficit hawks or deficit peacocks. Deficit peacocks should simply be ignored, and that is relevant to public debate. Hennessey himself may be a hawk and not a peacock. But this whole “America wants to move forward” line, by obscuring the reasons why we face the problems we face, only makes it more likely that we will end up with the wrong solutions—or, more likely, no solutions at all.

By James Kwak

Elizabeth Warren Calls Out Wall Street

James Kwak | 09 Feb 2010

Although the Consumer Financial Protection Agency made it through the House more or less intact, the banking lobby is taking another, better shot at killing it in the Senate, and is planning to use the magic words: “big government” and “bureaucracy.” Elizabeth Warren wrote an op-ed for Tuesday’s *Wall Street Journal* that lays out the confrontation. For most of the past two decades, many Americans trusted the banking industry—not necessarily to be moral exemplars, but they trusted that the banks were basically doing what was right for customers and for the economy. Then in 2007-2008 that mood abruptly reversed, as it became apparent that unscrupulous mortgage lenders, the Wall Street banks that backed them, and the credit rating agencies had been ripping off mortgage borrowers on the one hand and investors on the other.

The big banks face a choice. They can agree to sensible reforms that protect consumers and rein in the excesses of the past decades. Or they can simply decide to screw customers, but do it openly this time, since they have so much market share it almost doesn’t matter what customers think. How else do you explain, say, Citigroup’s concocting a new credit card “feature” explicitly to get around a new requirement of the Credit CARD Act? Or Jamie Dimon saying that financial crises are something to be expected every five to seven years, so we should just get over it?

A year ago, it might have been possible to twist the banks’ arms hard enough to get them to agree to new ways of doing business (such as a CFPB), because they needed government support so badly. Now it’s too late. So the solution has to come from the other kind of arm-twisting—pressure from the president, the administration (that means you, Tim Geithner), and ordinary voters. If people feel screwed by the financial sector—and many of them should after the past decade—then they should want the CFPB.

But last month, Republican political consultant Frank Luntz wrote a memo laying out how Republicans could kill financial regulatory reform. “Ordinarily, calling for a new government program ‘to protect consumers’ would be extraordinary popular,” he wrote. “But these are not ordinary times. The American people are not just saying ‘no.’ They are saying ‘hell no’ to more government agencies, more bureaucrats, and more legislation crafted by special interests.” The goal is simple: to make

Americans think that the CFPB is their enemy, because it's part of the government, and that the banks are nice cuddly ewoks by comparison.

This is absurd.

We like to make fun of government in this country, but really, what are you and a few of your buddies going to do to fight JPMorgan Chase on your own? For all of our beloved rugged individualism (and our individual right to handguns), it doesn't do much good when you're up against your credit card issuer. There is no Chicago-school free market solution to an oligopoly that, on top of all its other advantages, has an implicit government guarantee that gives it a major funding cost advantage over its competitors. One of the purposes of government is to protect ordinary people from forces (hurricanes, terrorists, monopolies) against which free market forces do not provide adequate protection. This is why we need a Consumer Financial Protection Agency. And this is what Frank Luntz wants to trick people into forgetting.

By James Kwak

Revised Baseline Scenario: February 9, 2010

Caution: this is a long post (about 3,000 words). The main points are in the first few hundred words and the remainder is supportive detail. This material was the basis of testimony to the Senate Budget Committee today by Simon Johnson.

A. Main Points

1) In recent months, the US economy entered a recovery phase following the severe credit crisis-induced recession of 2008-09. While slower than it should have been based on previous experience, growth has surprised on the upside in the past quarter. This will boost headline year-on-year growth above the current consensus for 2010. We estimate the global economy will grow over 4 percent, as measured by the IMF's year-on-year headline number (their latest published forecast is for 3.9 percent), with US growth in the 3-4 percent range – calculated on the same basis.

2) But thinking in terms of these headline numbers masks a much more worrying dynamic. A major sovereign debt crisis is gathering steam in Europe, focused for now on the weaker countries in the eurozone, but with the potential to spillover also to the United Kingdom. These further financial market disruptions will not only slow the European economies – we estimate growth in the euro area will fall to around 0.5 percent Q4 on Q4 (the IMF puts this at 1.1 percent, but the January World Economic Outlook update was prepared before the Greek crisis broke in earnest) – it will also cause the euro to weaken and lower growth around the world.

3) There are some European efforts underway to limit debt crisis to Greece and to prevent the further spread of damage. But these efforts are too little and too late. The IMF also cannot be expected to play any meaningful role in the near term. Portugal, Ireland, Italy, Greece, and Spain – a group known to the markets as PIIGS, will all come under severe pressure from speculative attacks on their credit. These attacks are motivated by fiscal weakness and made possible by the reluctance of relatively strong European countries to help out the PIIGS. (*Section B below has more detail.*)

4) Financial market participants buy and sell insurance for sovereign and bank debt through the credit default swap market. None of the opaqueness of the credit default swap market has been addressed since the crisis of September 2008, so it is hard to know what happens as

governments further lose their credit worthiness. Generalized counter-party risk – the fear that an insurer will fail and thus bring down all connected banks – is again on the table, as it was after the collapse of Lehman.

5) Another Lehman/AIG-type situation lurks somewhere on the European continent, and again G7 (and G20) leaders are slow to see the risk. This time, given that they already used almost all their scope for fiscal stimulus, it will be considerably more difficult for governments to respond effectively if the crisis comes.

6) In such a situation, we should expect that investors scramble for the safest assets available – “cash”, which means short-term US government securities. It is not that the US has anything approaching a credible medium-term fiscal framework, but everyone else is in much worse shape.

7) Net exports have been a relative strength for the US economy over the past 12 months. This is unlikely to be the case during 2010.

8) In addition to this new round of global problems, the US consumer is beset by problems – including a debt overhang for lower income households, a soft housing market, and volatile asset prices. The savings rate is likely to fall from 2009 levels, but remain relatively high. Residential investment is hardly likely to recover in 2010 and business investment is too small to drive a recovery.

9) On a Q4-on-Q4 basis, the US will struggle to grow faster than 2 percent (the IMF forecast is for 2.6 percent). This within year pattern will likely involve a significant slowdown in the second half – although probably not an outright decline in output. The effects of fiscal stimulus will begin to wear off by the middle of the year and without a viable medium-term fiscal framework there is not much room for further stimulus – other than cosmetic “job creation” measures.

10) The Federal Reserve will start to wind down its extraordinary support programs for mortgage-backed securities, starting in the spring (although this may be delayed to some degree by international developments). The precise impact is hard to gauge, but this will not help prevent a slowdown in the second quarter.

11) On top of these issues, there is concern about the levels of capital in our banking system. The “too big to fail” banks are implicitly backed by the US government and for them the stress test of early 2009 played down the amount of capital they would need if the economy headed towards a “double-dip”-type of slowdown; the stress scenario used was

far too benign. In addition, small and medium sized banks have a considerable exposure to commercial real estate, which continues to go bad.

12) Undercapitalized banks tend to be fearful and curtail lending to creditworthy potential borrowers. This may increasingly be the situation we face in 2010.

13) Emerging markets are also likely to slow in the second half of the year. Twice recently we have assessed whether these economies can “decouple” from the industrialized world (in early 2008 and at the end of 2008). In both cases, emerging markets – with their export orientation and, for some, dependence on commodity prices – were very much caught up in the dynamics of richer countries’ cycle.

14) The IMF projects global growth, 4th quarter-on-4th quarter within 2010 at 3.9 percent, i.e., the same as their year-on-year forecast. We expect it will be closer to 3 percent.

15) Over a longer time-horizon, we will probably experience a global economic boom, based on prospects in emerging markets. With our current global financial structure, this brings with it substantial systemic risks (*see Section C below*).

B. From Greece to the US: The Globalized Financial Transmission Mechanism

1) The problems now spreading from Greece to Spain, Portugal, Ireland and even Italy portend major trouble ahead for the US in the second half of this year – particularly because our banks remain in such weak shape.

2) Greece is a member of the eurozone, the elite club of European nations that share the euro and are supposed to maintain strong enough economic policies. Greece does not control its own currency – this is in the hands of the European Central Bank in Frankfurt. In good times, over the past decade, this helped keep Greek interest rates low and growth relatively strong.

3) But under the economic pressures of the past year, the Greek government budget has slipped into ever greater deficit and investors have increasingly become uncomfortable about the possibility of future default. This impending doom was postponed for a while by the ability of banks – mostly Greek – to use these bonds as collateral for loans from the European Central Bank (so-called “repos”).

4) But from the end of this year, the ECB will not accept bonds rated below A by major ratings agencies – and Greek government debt no longer falls into this category. If the ECB will not, indirectly, lend to the Greek government, then interest rates will go up in the future; in anticipation of this, interest rates should rise now.

5) This spells trouble enough for an economy like Greece – or any of the weaker eurozone countries. Paying higher interest rates on government debt also implies a worsening of the budget; these are exactly the sort of debt dynamics that used to get countries like Brazil into big trouble.

6) The right approach would be to promise credible budget tightening over 3-5 years and to obtain sufficient resources – from within the eurozone (the IMF is irrelevant in the case of such a currency union) – to tide the country over in the interim.

7) But the Germans have decided to play hardball with their weaker neighbors – partly because those countries have not lived up to previous commitments. The Germans strongly dislike bailouts – other than for their own banks and auto companies. And the European policy elite loves rules; in this kind of situation, their political process will move at a relatively slow late 20th century pace.

8) In contrast, markets now move in a 21st century global network pace. We are moving towards is a full-scale speculative attack on sovereign credits in the eurozone. Brought on by weak fundamentals – worries about the budget deficit and whether government debt is on explosive path – such attacks take on a life of their own. We should remember – and prepare for – a spread of pressure between countries along the lines of the panic that moved from Thailand to Malaysia and Indonesia, and then then jumped to Korea all in the space of two months during 1997.

9) The equity prices of weaker European banks will come under pressured. Fears about their solvency may also be reflected in higher credit default swap spreads, i.e., a higher cost of insuring against their default.

10) US Treasury and the White House apparently take the view that they must stand aloof, waiting for the Europeans to get their act together. This is a mistake – the need for US leadership has never been greater, particularly as our banks are really not in good enough shape to withstand a major international adverse event (e.g., Greece defaults, Greece leaves the eurozone, Germany leaves the eurozone, etc).

11) We subjected our banks to a stress test in spring 2009 – but the stress scenario was mild and more appropriate as a baseline. Many of our banks – big, medium, and small – simply do not have enough capital to withstand further losses.

12) As the international situation deteriorates – or even if it remains at this level of volatility – undercapitalized banks will be reluctant to lend and credit conditions will tighten around the US.

13) If the European situation spins seriously out of control, as it may well do in coming weeks, the likelihood of a double-dip recession (or significant slowdown in the second half of 2010) increases dramatically.

C. Longer Run Baseline Scenario

1) In terms of thinking about the structure of the global economy there are three main lessons to be learned from the past eighteen months.

2) First, we have built a dangerous financial system in Europe and the U.S., and 2009 made it more dangerous.

- The fiscal impact of the financial crisis was to increase by around 30-40 percent points our federal government debt held by the private sector. The extent of our current contingent liability, arising from the failure to deal with “too big to fail” financial institutions, is of the same order of magnitude.
- Our financial leaders have learnt that they can bet the bank, and, when the gamble fails, they can keep their jobs and most of their wealth. Not only have the remaining major financial institutions asserted and proved that they are too big to fail, but they have also demonstrated that no one in the executive or legislative branches is currently willing to take on their economic and political power.
- The take-away for the survivors at big banks is clear: We do well in the upturn and even better after financial crises, so why fear a new cycle of excessive risk-taking?

3) Second, emerging markets were star performers during this crisis. Most global growth forecasts made at the end of 2008 exaggerated the slowdown in middle-income countries. To be sure, issues remain in places such as China, Brazil, India and Russia, but their economic policies and financial structures proved surprisingly resilient and their growth prospects now look good.

4) Third, the crisis has exposed serious cracks within the euro zone, but also between the euro zone and the U.K. on one side and Eastern

Europe on the other. Core European nations will spend a good part of the next decade bailing out the troubled periphery to avoid a collapse. For many years this will press the European Central Bank to keep policies looser than the Germanic center would prefer.

5) Over the past 30 years, successive crises have become more dangerous and harder to sort out. This time not only did we need to bring the fed funds rate near to zero for “an extended period” but we also required a massive global fiscal expansion that has put many nations on debt paths that, unless rectified soon, will lead to their economic collapse.

6) For now, it looks like the course for 2010 is economic recovery and the beginning of a major finance-led boom, centered on the emerging world.

7) But this also implies great risks. The heart of the matter is, of course, the U.S. and European banking systems; they are central to the global economy. As emerging markets pick up speed, demand for investment goods and commodities increases –countries producing energy, raw materials, all kinds of industrial inputs, machinery, equipment, and some basic consumer goods will do well.

8) On the plus side, there will be investment opportunities in those same emerging markets, be it commodities in Africa, infrastructure in India, or domestic champions in China.

9) The Chinese exchange rate will remain undervalued. Our reliance on Chinese purchases of US government and agency debt puts us at a significant strategic disadvantage and makes it hard for the administration to push for revaluation. The existing multilateral mechanisms for addressing this issue – through the IMF – are dysfunctional and will not help. There is a growing consensus to move exchange issues within the remit of the World Trade Organization but, without US leadership, this will take many years to come to fruition.

10) Good times will bring surplus savings in many emerging markets. But rather than intermediating their own savings internally through fragmented financial systems, we’ll see a large flow of capital out of those countries, as the state entities and private entrepreneurs making money choose to hold their funds somewhere safe – that is, in major international banks that are implicitly backed by U.S. and European taxpayers.

11) These banks will in turn facilitate the flow of capital back into emerging markets –because they have the best perceived investment

opportunities – as some combination of loans, private equity, financing provided to multinational firms expanding into these markets, and many other portfolio inflows. Citigroup, for example, is already emphasizing its growth strategy for India and China.

12) We saw something similar, although on a smaller scale, in the 1970s with the so-called recycling of petrodollars. In that case, it was current-account surpluses from oil exporters that were parked in U.S. and European banks and then lent to Latin America and some East European countries with current account deficits.

13) That ended badly, mostly because incautious lending practices and – its usual counterpart – excessive exuberance among borrowers created vulnerability to macroeconomic shocks.

14) This time around, the flows will be less through current- account global imbalances, partly because few emerging markets want to run deficits. But large current-account imbalances aren't required to generate huge capital flows around the world.

15) This is the scenario that we are now facing. For example, savers in Brazil and Russia will deposit funds in American and European banks, and these will then be lent to borrowers around the world (including in Brazil and Russia).

16) Of course, if this capital flow is well-managed, learning from the lessons of the past 30 years, we have little to fear. But a soft landing seems unlikely because the underlying incentives, for both lenders and borrowers, are structurally flawed.

17) The big banks will initially be careful – although Citigroup is already bragging about the additional risks it is taking on in India and China. But as the boom progresses, the competition between the megabanks will push toward more risk-taking. Part of the reason for this is that their compensation systems remain inherently pro-cyclical and as times get better, they will load up on risk.

18) The leading borrowers in emerging markets will be quasi-sovereigns, either with government ownership or a close crony relationship to the state. When times are good, investors are happy to believe that these borrowers are effectively backed by a deep-pocketed sovereign, even if the formal connection is pretty loose. Then there are the bad times – remember Dubai World at the end of 2009 or the Suharto family businesses in 1997-98.

19) The boom will be pleasant while it lasts. It might go on for a number of years, in much the same way many people enjoyed the 1920s. But we have failed to heed the warnings made plain by the successive crises of the past 30 years and this failure was made clear during 2008-09.

20) The most worrisome part is that we are nearing the end of our fiscal and monetary ability to bail out the system. In 2008-09 we were lucky that major countries had the fiscal space available to engage in stimulus and that monetary policy could use quantitative easing effectively. In the future, there are no guarantees that the size of the available policy response will match the magnitude of the shock to the credit system.

21) Much discussion of the Great Depression focuses on the fact that the policy response was not sufficiently expansionary. This is true, but even if governments had wanted to do more, it is far from clear that they had the tools at their disposal – in particular, the size of government relative to GDP is limited, while the scale of financial sector disruption can become much larger.

22) We are steadily becoming more vulnerable to economic disaster on an epic scale.

By Peter Boone, Simon Johnson, and James Kwak

President Obama On CEO Compensation At Too Big To Fail Banks

Simon Johnson | 10 Feb 2010

Bloomberg today reports President Obama as commenting on the \$17 million bonus for Jamie Dimon of JP Morgan Chase and the \$9 million bonus for Lloyd Blankfein of Goldman Sachs,

“I know both those guys; they are very savvy businessmen,”

and

““I, like most of the American people, don’t begrudge people success or wealth. That is part of the free- market system.”

Taken separately, these statements are undeniably true. But put them together in the context of the Bloomberg story – we have to wait until Friday for the full text of the interview – and the White House has a major public relations disaster on its hands.

Does the president truly not understand that Dimon and Blankfein run banks that are regarded by policymakers and hence by credit markets as “too big to fail”?

This is the antithesis of a free-market system. Not only were their banks saved by government action in 2008-09 but the overly generous nature of this bailout (details here) means that the playing field is now massively tilted in favor of these banks. (I put this to Gerry Corrigan of Goldman and Barry Zubrow of JP Morgan when we appeared before the Senate Banking Committee last week; there was no effective rejoinder.)

Not only that, but the incentives for the people running these megabanks is now to take on reckless amounts of risk. They get the upside (for example, in these compensation packages) and – when the downside materializes – this is belongs to taxpayers and everyone who loses a job. (See my testimony to the Senate Budget Committee yesterday; there was no disagreement among the witnesses or even across the aisle between Senators on this point.)

Being nice to the biggest banks will not save the midterm elections for the Democrats. The banks’ campaign contributions will flow increasingly to the Republicans and against any Democrats (and there are precious few) who have fought for real reform.

The president's only political chance is to take on the too big to fail banks directly and clearly. He needs to explain where they came from (answer: the Reagan Revolution, gone wrong), how the problem became much worse during the last administration, and how – in credible detail – he will end their reign.

What we have now is not a free market. It is rather one of the most complete (and awful) instances ever of savvy businessmen capturing a state and the minds of the people who run it. Is this really what the president seeks to endorse?

By Simon Johnson

Radio Stories

James Kwak | 10 Feb 2010

I spend a lot of time in the car driving to and from school, so I end up listening to a lot of podcasts (mainly This American Life, Radio Lab, Fresh Air, and Planet Money). I was catching up recently and wanted to point out a few highlights.

Last week on Fresh Air, Terry Gross interviewed Scott Patterson, author of *The Quants*, and Ed Thorp, mathematician, inventor of blackjack card counting (or, at least, the first person to publish his methods), and, according to the book, also the inventor of the market-neutral hedge fund. These are some of Thorp's comments (around 24:20):

"As far as you can tell now, how are quants being used on Wall Street? Are these mathematical models being relied on as heavily now after the stock market crash as they were before?"

"My impression is: pretty much. There's a giant industry now; many thousands of people who otherwise would have gone into engineering and science have gone over to Wall Street to work on these things because the pay is better and it's fun. They're still there — they have a vested interest in staying there — and I think a lot of people think that we're just going to go back to business as usual in this country, that this is all going to blow over and we're not going to have any significant increase in regulation, we're not going to have any significant listing of off-the-book derivatives on exchanges like the commodity futures exchanges, and that we'll set ourselves up for another big fall. That's what I'm afraid will happen."

"So, how is that affecting how much you want to have invested in the market?"

"Well, it's tough. The question is where do you go. We only have one world we live in. If they had a market on Mars, I might think about going there. But I think it's going to be very difficult. I personally find it hard to guess exactly when some bad thing will happen and how long it will take and what will trigger it, just like in this last crash. You know something bad's going to happen; you just don't know when or how."

A few weeks back, Planet Money had an interview with MIT finance professor Andrew Lo, where he repeated his call for a financial industry equivalent to the National Transportation Safety Board, which investigates airline crashes and recommends new procedures to protect against crashes in the future. Lo also gave a reasonable explanation and defense of proprietary trading. But the unsatisfying thing was that his main argument for proprietary trading was that it provides liquidity (beginning around 9:30), which Alex Blumberg calls him out on. Even after Lo explains it, though, he doesn't explain why we need *large banks'* proprietary trading desks to provide liquidity. After all, isn't that what hedge funds do? How much liquidity do we need, and how much of that is supplied by institutions with banking licenses? And at the least, couldn't the large banks at least spin off their internal hedge funds? Then you would have just as much trading, but less of it would be backed up by government guarantees.

I finally got around to listening to Planet Money's interview with Russ Roberts from December. Russ Roberts and I are pretty sure to disagree on almost any actual policy question. But what I liked about his interview was that he basically admitted that policy questions cannot be settled by looking at the empirical studies. On whether the minimum wage increases or decreases employment for example, he says that he can poke holes in the studies whose conclusions he doesn't agree with, but other people can poke holes in the studies he agrees with. In Roberts's view, people's policy positions are determined by their prior normative commitments.

I don't completely agree. I don't think that these questions, like the one about the minimum wage, are inherently unanswerable in the sense that the answer does not exist. But I agree that empirical studies are unlikely to get to the truth, particularly on a politically charged question, because there are so many ways to fudge an empirical study. As one of my professors said, there are a million ways you can screw up a study, and only one way to do it right. But I agree with the general sentiment. We are living in an age of numbers, where people think that statistics can answer any question. Statistics can answer any question, but they can answer it in multiple ways depending on who is sitting at the keyboard.

By James Kwak

Bankers and Athletes, Part 2

James Kwak | 10 Feb 2010

In a recent [interview with Bloomberg](#) ([Simon's commentary here](#)), President Obama compared bank CEOs to athletes—a analogy favored by Goldman director [Bill George](#), among others. However, Obama got the analogy right:

“The president, speaking in an interview, said in response to a question that while \$17 million is ‘an extraordinary amount of money’ for Main Street, ‘there are some baseball players who are making more than that and don’t get to the World Series either, so I’m shocked by that as well.’”

That is, Obama is saying that some bankers are overpaid, just like some athletes are overpaid. Maybe he read my [earlier post](#)?

There, I wrote:

“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.”

More generally, Obama is trying to strike a balance: put pressure on Wall Street while not appearing to be wielding a pitchfork himself. This is why he felt compelled to say, “I, like most of the American people, don’t begrudge people success or wealth. That is part of the free-market system.” At the same time he feels compelled to advocate for relatively mild reforms, such as paying bonuses in stock instead of cash, which is [at best a partial solution](#). (Top Wall Street executives were already paid overwhelmingly in stock rather than cash before the financial crisis.)

I’m not sure why he needs to strike that balance. CEOs are overpaid, [bankers are overpaid](#), and bank CEOs are overpaid. Why not just say it plainly?

By James Kwak

Robert Samuelson Again

James Kwak | 10 Feb 2010

Remind me never to open *Newsweek* again when I have real work to do. Robert Samuelson tries to play the tough guy yet again in his column, saying that we face either major entitlement cuts or major tax increases and we have to buck up and take it like real men. I agree that we need to do something about the long-term debt problem, and the sooner we come up with a solution the better. But this was what set me off: “There is no way to close the massive deficits without big cuts in existing government programs or stupendous tax increases.”

This leaves out the obvious and best solution: reduce the growth rate of health care costs. Democrats and Republicans differ on how to do it—the former put a large package of cost-cutting measures in the Senate version of the health care reform bill, the latter want to kill the tax exclusion for employer-sponsored health care (and some Democrats would be fine with that as well). But everyone knows that the long-term debt problem is a health care problem, we spend far more on health care than we get back in outcomes, and cutting health care cost growth is the key. If we don’t, then we’re completely screwed no matter how much we cut Medicare—someone has to pay those health care costs, and if we cut entitlements we’re just shifting the problem onto individuals. (Put another way, Medicare is largely a redistribution system—as Samuelson recognizes—and if you kill it, you haven’t done anything about the fundamental mismatch between aggregate income and aggregate health care costs.) You may prefer that politically, but it’s still not a solution.

Samuelson says, “Even with these cuts [proposed by him], future taxes would need to rise. Unless you’re confronting these issues—and Obama isn’t—you’re evading the central budget problems.” Does he not realize that health care reform was the centerpiece (now perhaps failed, but at least he tried) of Obama’s first year in office, and that Obama himself insisted that cost reduction was more important than universal coverage, to the chagrin of his own political base? Oh, wait. Samuelson doesn’t realize that health care *is* the central budget problem.

I’m sorry to belabor the point. You all know it. But apparently Robert Samuelson doesn’t.

By James Kwak

Is Larry Summers Getting Tougher?

Simon Johnson | 11 Feb 2010

Financial regulation is currently in no-man's land, having emerged more or less intact from the House frying pan before facing the gauntlet of the Senate.

To its credit, the Obama administration has in recent weeks taken a firmer position: The excesses of the past decade have to come to an end. This was evident three weeks ago in the new proposals announced by the president to constrain the activities of large banks, which went beyond anything the Treasury Department had proposed last summer.

It was also evident in an interview that Lawrence H. Summers, the president's chief economic counselor, gave to CNBC on Tuesday. (Ryan Grim has transcribed additional quotations.)

Asked whether the United States has "transitioned into a financial services economy," Mr. Summers responded:

"The president's been emphatic on what have been the excesses of the financial sector — irresponsibility, innovation that served no real purpose except the exploitation of customers — and that's why the president's pushed so hard for strengthened financial regulation. Look, a healthy financial system is crucial to a healthy economy, but we don't need the kind of hypertrophy that we've seen in the financial system in recent years. . . ."

"We're certainly emphasizing regulating the bankers now, not supporting the kind of irresponsible growth that we saw historically."

This seems to represent another modest shift away from the administration's position over the last year. The administration has repeatedly emphasized the need for better regulation — who could argue with that? — but was not closely linked to the idea that the financial sector is simply too big. The idea that some, if not most, financial innovation has served only to exploit customers is also a recent addition to the administration's verbal arsenal. (More background on this view is here.)

The fact that Mr. Summers is doing the talking may also be significant.

Although Mr. Summers, as director of the National Economic Council, is widely believed to be the administration's chief economic policy maker, when it comes to financial regulation the front man has primarily been Treasury Secretary Timothy F. Geithner, who has been widely perceived as being overly friendly to the banking industry. By remaining out of the limelight, Mr. Summers has preserved the ability to take a tougher line on Wall Street.

That line may be emerging now, just in time for the bruising battle ahead in the Senate.

Of course, it may amount to nothing more than a new marketing campaign designed for political consumption, intended to show that the Democrats are being tough on rich Wall Street bankers. In particular, it seems that the new size limits on banks will be designed to limit growth *from this point forward*— implying that our current \$2 trillion banks are just fine the way they are.

Still, however, the idea that the financial sector is simply too big is a clear and welcome line in the sand.

Over the past two decades, high returns in the financial sector — for shareholders but even more so for employees — have fueled the “hypertrophy” that Mr. Summers referred to.

Not only did money flow into real estate and leveraged buyouts that would have been better invested in real productive capacity, but many smart, ambitious, hard-working people took jobs on Wall Street instead of starting new companies or inventing new products. Since 2007, we have learned that those high returns were illusory: Profits gained when assets rose in value, but were matched by catastrophic losses when the bubble finally popped.

The real question, then, is what reforms the administration will fight for that will actually shrink the size of the financial sector, since there is no evidence that the sector will simply shrink by itself.

While the sector has undergone significant deleveraging, there is no reason for it not to simply leverage up again when the opportunity presents itself. So far the administration has resisted the idea of forcing large banks to become smaller; however, if it succeeds in reducing the size of the sector without breaking up the big banks, the big banks will only have even greater market share and market power.

But now that Mr. Summers has clearly pointed out the problem, we can assess in coming weeks — as the legislative debate on financial

reform intensifies in the Senate — whether the administration has a workable strategy for fixing finance.

By Simon Johnson

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The Myth of Efficiency

James Kwak | 12 Feb 2010

By James Kwak

Planet Money's latest podcast features an interview with Matt LeBlanc, an efficiency expert. LeBlanc's job is to observe various processes and figure out ways to make them more efficient. The idea, is that by increasing efficiency companies can save money, which ends up helping everyone through higher productivity and lower prices, even if some people get laid off along the way.

I am as much of a compulsive efficiency nerd as anyone (well, almost anyone). LeBlanc lays out his toiletries in the morning in a specific order in order to minimize transition time. When I lived in Berkeley, I figured out the fastest way to drive to school. The various possible routes were different paths through a grid that included some stop signs and some street lights; the best route involved slowing down at one intersection, looking to see if what color the light at an intersection was, and making a decision based on that. On one of my previous blogs I wrote a post about the quickest way to get through a security line at an airport. (Tip #1: Don't unload your bags into the plastic trays until shortly before you reach the X-ray scanner. Your bags were designed to help you carry a lot of stuff with two hands; if you unpack them early, you have to move your unpacked stuff with the same two hands. Tip #2: Put your bags through the scanner before your computer and toiletries bag; that way you can have your bags ready and waiting on the other end so you can pick up the computer and slide it into your bag in one motion.) One of my pet peeves is businesspeople who fly frequently, make faces when standing behind families in the security line, and then *slow down the line themselves* because they haven't figured out how to get their stuff onto the conveyor belt immediately after the person in front of them.

But I've become very skeptical of the simple argument for efficiency studies. (To be fair, LeBlanc is probably equally skeptical; but the podcast only put forward the simple argument.) The idea is that time has a monetary value (say, the per-hour employment costs of each employee), and if you save time, you save money. One example that LeBlanc mentions is moving printers. It seems to make sense on its face. You spend time walking to and from the printer. Therefore, printers should be located to minimize the total time people spend in transit, which could mean moving the printer closer to the heavy users of

printing. Then those people can spend more time at their desks being productive.

But there is a serious fallacy in this argument: the assumption that the constraint on productivity is *time at your desk*. Let's leave aside the issue of whether you are productive walking to the printer. The more serious issue is that you aren't equally productive the whole time you sit at your desk. What if you spend your extra two minutes (in reduced time picking up printouts) at I Can Has Cheezburger?

Well, the efficiency expert may counter, all I need to assume is that a *fixed percentage* of your desk time is productive. But that's still a big assumption. Maybe the real constraint on your daily productivity is mental energy, and you only have enough mental energy to do four hours of real work a day. Then your extra two minutes will all go to looking at pictures of cats with ungrammatical captions. Even more likely, maybe the real constraint is *your internal sense of what a reasonable day's work is*. Many of us have either left early because we got a lot done or stayed late because we got little done. Maybe the real constraint is how much work your supervisor expects you to do. Maybe the real constraint is how much your colleagues get done, either for process reasons or simply because workplace norms are set by group as a whole. Maybe the real constraint is your motivation level. Maybe the real constraint is customer demand. (Another of LeBlanc's examples is a cafe where the barista only spends half his time actually making a drink; the most plausible explanation is that you need to staff for potential demand, but actual demand fluctuates and is generally below potential demand.)

All of these possibilities seem much more likely to me than the idea that the limiting constraint is time spent at your desk. And if any of them is true, then moving the printer has gained you nothing.

You might think this is less true of more routine tasks, like moving and unpacking boxes (another LeBlanc example). Maybe, but I'm still skeptical. Let's say you figure out a way to unload a truck, unpack the boxes, and put the stuff where it should go in half the time as before. Will the same people get twice as much done? Maybe, but I doubt it. Again, this assumes that the binding constraint on productivity is time. What if the work is physically strenuous, and while the old process included a lot of unnecessary pauses, those pauses were necessary to allow people enough time to rest? Then if you try to push them twice as hard, using a more efficient process, their bodies will break down. (If

you could actually cut the effort in half, though, you might be onto something.) What if the limiting constraint is boredom: people just can't work at peak efficiency for eight hours straight, and the old process with its delays gave them time to chat, look around, and relax a bit while working?

In many tasks, there is probably some room for efficiency improvement that can actually result in sustained higher productivity. But the benefits are only a fraction of the theoretical benefits you get by multiplying time savings by the money value of time.

BlackBerry (and its competitors) have made a fortune off the myth of efficiency. The reason BlackBerry is so popular with corporations is the idea that now people can be working while waiting in lines at the airport.* (Judging from the ads, this is *the* core use case.) That time is now money, at least according to the efficiency theory. But what are people doing? They are clearing out emails. If there is any benefit to anyone, it is that they will spend a little less time in the evening clearing out emails on their computers; but they won't be doing any other work, because the length of their workday isn't set by a clock, but by their sense of when they've done enough for the day. (For a lot of people, their willingness to knock off at the end of the day is related to the amount of email left in their inboxes.)

In addition, a lot of the supposed BlackBerry benefit is destroyed by four factors. First, working on a BlackBerry is less efficient than working on a computer (it takes more time to get the same stuff done), so some of your benefit (time waiting in line) is wasted in lower productivity. Second, checking your email constantly causes you to respond to emails and deal with issues that you could have simply ignored had you waited until you got home or to your hotel (since questions or issues posed in email often resolve themselves if you simply wait a few hours). Third, having a BlackBerry causes you to spend more time on email than you need to, *because you can*. Fourth, the quality of work you do on a BlackBerry is lower than on a computer. For example, with a computer, you can answer a question by finding a specific data source and actually finding the answer; with a BlackBerry, you are more likely to give an unhelpful answer like "try looking at source X," which you may have misidentified, and which is less helpful to the person asking the question. But people lobby their companies to pay for their BlackBerrys because they want them, and companies often agree because they think they're getting a more efficient workforce.

In case you're wondering, I have no BlackBerry and no similar device for checking email while waiting in airport lines. (My dumbphone can, in a real pinch, check my email, but it's so bad at it I rarely use it.)

* Obviously, there are some professions where constant accessibility is an issue—say, IT support personnel. The vast majority of BlackBerry users do not fit into this category.

Update: I should have emphasized that I agree with the basic point that there are vast, vast inefficiencies in the economy that, if eliminated, could have enormous benefits for all of us. In particular, we could make much more use of automation, especially through the expanded use of software (if we could find software companies that make software that works well, that is). Completely eliminating human touches reduces effort and takes all those other binding constraints I mentioned above off the table. Software can also sift through vast numbers of similar cases and determine which ones require skilled human intervention and which ones can be handled automatically according to some set of rules. We have made enormous advances in automation of manufacturing over the last century; I think we can make analogous, though smaller, gains through the automation of many service industries. What I'm more skeptical of are time-and-motion efficiency gains, especially when it comes to knowledge workers.

Waiting For The G7 On The Euro

Simon Johnson | 12 Feb 2010

By Simon Johnson

Yesterday's announcement of European "support" for Greece was badly bungled.

The Global Crisis Fighter's Guide to the Galaxy clearly states that when "markets overreact... policy needs to overreact as well" (see Larry Summers's 2000 Ely Lecture to the American Economic Association, *American Economic Review*, vol. 90, no. 2, p.11; no free link available – and yes, I know that the White House doesn't always follow its own playbook).

This definitely does not mean: Vague promises to provide some support in an unspecified fashion in return for some policy actions to be specified later.

Irrespective of your view on how much fiscal adjustment Greece needs vs. how much German taxpayer money it deserves (or can realistically expect), you need a different approach – much more concrete and detailed. The only good news yesterday was that the IMF will play a slightly greater role than previously expected, but even this change was a nuance missed by everyone – and who knows where it will lead.

If the euro continues to depreciate as it has so far today, the G7 will need to weigh in. It's not that the G7 can, in the short-term, do anything at all. But in the highly ritualized theater of speculative attacks, the G7 carries the big stick – the threat of currency intervention.

Waving this stick is not without its complications – particularly if it is not backed up by real policy actions. And the Americans (and Japanese and Canadians), on the basis of the last week, have every reason to push the Europeans to "show, don't tell."

Still, talk is cheap and the Europeans are starting to sound a little desperate. Expect the G7 to come in this weekend with a statement about concern regarding potentially disorderly adjustment in major currency markets.

Let's hope this buys some time – and that the Europeans use that wisely.

Some Survey Results

James Kwak | 12 Feb 2010

By James Kwak

Here are the results of the latest New York Times/CBS News poll. (Here's the Times article.) A few observations:

1. When asked what the most important problem facing the country is (question 4), here are the winners:

- Jobs: 27%
- Economy: 25%
- Other: 16%
- Health Care: 13%
- Budget Deficit: 4%
- DK/NA: 4%

This shows the divide between the country, which cares about jobs, and the Washington punditocracy, which cares (or professes to care) about the deficit. Now, I'm not saying that something's actual importance is a function of its perceived importance. Governing requires doing what's best for the country, whether or not people realize it. But neither is it true to say that Americans are overwhelmingly concerned about the deficit. They're not. And looking at the numbers, you would think most would favor increased spending or lower taxes to create jobs. Later on, though, when given that explicit question, we find a much smaller margin (47-45) in favor of jobs. This, of course, is largely an artifact of question design, so you can argue about which design is more relevant depending on what question you're trying to answer.

2. On questions 6-10, Obama gets positive marks for foreign policy and terrorism, but negative marks for the economy, health care, and the deficit. This is what you would expect for a Republican president, not a Democratic one (with the possible exception of the deficit question, since Democrats are still seen as big spenders, the past two administrations notwithstanding). Probably the most likely explanation is that the last three are simply things that people are unhappy about in general; also, the economy and health care are issues where Obama faces disapproval both from the right and the left, for opposite reasons. Basically, we have a centrist president.

3. Only 8% of Americans think that "most members of Congress" deserve re-election. This, it seems to me, is one of those survey results that is inherently self-defeating. All of the Republican base should be

happy with Republican Congressmen for successfully fighting off the Obama agenda. Many though not all Democrats no doubt blame the last year on the Republicans and should be reasonably happy with their Congressmen. And we know the vast majority of members of the House will be returned to office. So all this means is that people have an unfocused antipathy toward Congress as an institution.

4. When you ask if “homosexuals” should be allowed to serve in the military (page 24), people are in favor 59-29. When you ask about “gay men and lesbians,” you get 70-19. (If you follow up by asking about serving “openly,” the margin falls to 44-41 and 58-28, respectively.) Words matter.

Google Buzz and Public Search Results

James Kwak | 12 Feb 2010

By James Kwak

Some law school friends and I had trouble figuring this out two nights ago when Buzz was apparently rolled out, so I thought this might be helpful. I think I got it right, but no guarantees. Note that this post is about including your profile in public search results; there is another more important privacy issue [discussed here](#).

In the process of using Buzz, at various points Google asks you to create a public profile. The Edit Profile screen looks like this:

If you uncheck the upper-right box, then your profile will not be included in public search results. When you save your edited profile, you'll get a message including this text: "Your profile is currently not findable via search on Google because we don't have permission to display your name." Sounds good — except the next time you try to comment on anything on Buzz, you will get a dialog box saying "How do you want to appear to others?" In order to successfully comment, you have to click the "Save profile and continue" button.

The next time you look at your profile, you'll notice that that upper-right box — "Display my full name so I can be found in search" — is now checked. That's what happened when you clicked "Save profile and continue." So it seems like in order to use Buzz, you have to have a public profile.

However, there seems to be a loophole. My profile contains only my first name, last name, nickname, and photo. (OK, my late dog's photo.) When I save my profile, even with the upper-right box checked, I get this message: "Your profile is not yet eligible to be featured in Google search results. To have your profile featured, add more information about yourself." So it seems like you can use Buzz (although I'm still not sure why I would) and keep your profile out of Google search results, simply by not providing much information about yourself.

Your mileage may vary.

Greece Derails – Is Europe Far Behind?

Simon Johnson | 13 Feb 2010

By Simon Johnson

Already facing serious difficulties – both internal and with regard to its EU partners (see [our longer essay in Saturday's WSJ](#)) – Greece's predicament just became substantially worse.

Speaking on national television this evening, the Greek Prime Minister – George Papandreou – lashed out at the European Union (presumably meaning mostly Germany) for creating a “[psychology of looming collapse which could be self-fulfilling](#).” He also implied that Greece was being treated, in some senses, like a “lab animal.”

Without doubt, EU engagement with Greece over the past week or three has not been well-managed – and the pseudo-announcement of support after the summit on Thursday was a [complete amateur hour](#).

But Greece has real problems that need to be confronted and it will go much easier for everyone if there is external assistance. You cannot overspend in the Greek fashion without eventually facing a reckoning.

The Greek government is implicitly suggesting collapse – with the possibility of contagion to Portugal and Spain (and thence to the banking system of Latin America, etc). But this is a very dangerous game. Greece is not Goldman Sachs – it cannot credibly threaten to bring down the world's entire financial system.

Less well-run countries default on their debts with some regularity. To be sure, it is awkward for a eurozone member to be forced into the arms of the IMF – but several European Union members are there already (e.g., Latvia, Romania.) Korea had to borrow from the Fund in 1997, despite having recently become a member of the OECD – which stamp previously was considered to connote respectability and stability.

Greece is well down the path to becoming regarded more like Argentina – a country that struggles over many decades (and whose leaders frequently rail against the world) and for which episodes of reasonable prosperity and new economic models are punctuated by gut-wrenching crises, most of which do not shake the world.

Will the EU save Greece? Much will depend on how bad the situation could become in other “related” (in the eyes of the financial markets) places.

But destabilizing actions or inflammatory statements by Greece make an orderly rescue less likely and put another major international economic crisis firmly on the table.

Goldman Goes Rogue – Special European Audit To Follow

Simon Johnson | 15 Feb 2010

At 9:30pm on Sunday, September 21, 2008, Goldman Sachs was saved from imminent collapse by the announcement that the Federal Reserve would allow it to become a bank holding company – implying unfettered access to borrowing from the Fed and other forms of implicit government support, all of which subsequently proved most beneficial. Officials allowed Goldman to make such an unprecedented conversion in the name of global financial stability. (The blow-by-blow account is in Andrew Ross Sorkin's *Too Big To Fail*; this is confirmed in all substantial detail by Hank Paulson's memoir.)

We now learn – from Der Spiegel last week and today's NYT – that Goldman Sachs has not only helped or encouraged some European governments to hide a large part of their debts, but it also endeavored to do so for Greece as recently as last November. These actions are fundamentally destabilizing to the global financial system, as they undermine: the eurozone area; all attempts to bring greater transparency to government accounting; and the most basic principles that underlie well-functioning markets. When the data are all lies, the outcomes are all bad – see the subprime mortgage crisis for further detail.

A single rogue trader can bring down a bank – remember the case of Barings. But a single rogue bank can bring down the world's financial system.

Goldman will dismiss this as “business as usual” and, to be sure, a few phone calls around Washington will help ensure that Goldman's primary supervisor – now the Fed – looks the other way.

But the affair is now out of Ben Bernanke's hands, and quite far from people who are easily swayed by the White House. It goes immediately to the European Commission, which has jurisdiction over eurozone budget issues. Faced with enormous pressure from those eurozone countries now on the hook for saving Greece, the Commission will surely launch a special audit of Goldman and all its European clients.

This audit should focus on ten sets of questions.

1. Which eurozone governments have worked with Goldman, and on what basis, over the past decade? All actions prior to and after the introduction of the euro need to be thoroughly reexamined.

2. What transactions has Goldman facilitated and how has that affected the reporting of European government debt? (Under the Maastricht Treaty, eurozone government debt is not supposed to exceed 60 percent of GDP.)
3. In the case of Greece, the accusation is that Goldman deliberately and in a premeditated manner conspired to hide the true degree of government debt. Is this true, and to what extent has Goldman helped other countries engage in similar transactions, e.g., countries now seeking entry to the eurozone?
4. What is the full extent of Greek and other government liabilities, if these are accounted for properly? Without this reckoning, it is impossible to design a proper level of European Union (or any other) support for weaker eurozone countries.
5. Are there non-eurozone countries that have also been aided and abetted by Goldman in this fashion? For example, are the UK and Switzerland implicated – and thus endangered?
6. Has Goldman extolled the virtues of government debt in Greece, or other countries, while at the same time helping to deceive investors on the true risks inherent in those debts? What were Goldman's own holdings of these securities?
7. Is there evidence that Goldman has structured similar transactions for the private sector – enabling companies to conceal the level of their true indebtedness? Have securities issued by such firms also been endorsed by Goldman to the buying public?
8. Were Goldman's US-based supervisors aware of Goldman's activities in Greece and other eurozone countries? Did they condone activities that undermine the integrity of the European Union?
9. Where was the European Central Bank while all of this was happening? Has the ECB become dangerously enraptured with the new Wall Street and its "techniques"?
10. Did any responsible official really think that what Goldman was constructing was really some sort of productivity-enhancing financial innovation – as opposed to a sophisticated form of scam?

The Federal Reserve must cooperate fully with this investigation. Ordinarily, the Fed might be tempted to sit on useful information, but they can now feel themselves in Senator Bob Corker's crosshairs. Republican Senator Corker is willing to cooperate with Senator Dodd on financial sector reform, opening up the possibility of legislation that will pass the Senate, but he wants the Fed to lose its supervisory powers. If

the Fed refuses to help – willingly and fully - the European Commission with bringing Goldman to account, that will just strengthen the hand of Senator Corker and his allies.

If the Federal Reserve were an effective supervisor, it would have the political will sufficient to determine that Goldman Sachs has not been acting in accordance with its banking license. But any meaningful action from this direction seems unlikely.

Instead, Goldman will probably be blacklisted from working with eurozone governments for the foreseeable future; as was the case with Salomon Brothers 20 years ago, Goldman may be on its way to be banned from some government securities markets altogether. If it is to be allowed back into this arena, it will have to address the inherent conflicts of interest between advising a government on how to put (deceptive levels of) lipstick on a pig and cajoling investors into buying livestock at inflated prices.

And the US government, at the highest levels, has to ask a fundamental question: For how long does it wish to be intimately associated with Goldman Sachs and this kind of destabilizing action? What is the priority here - a sustainable recovery and a viable financial system, or one particular set of investment bankers?

To preserve Goldman, on incredibly generous terms, in the name of saving the financial system was and is hard to defend – but that is where we are. To allow the current government-backed (massive) Goldman to behave recklessly and with complete disregard to the basic tenets of international financial stability is utterly indefensible.

The credibility of the Federal Reserve, already at an all-time low, has just suffered another crippling blow; the ECB is also now in the line of fire. Goldman Sachs has a lot to answer for.

By Simon Johnson

The Next Problem

James Kwak | 15 Feb 2010

There has been a lot of talk about the financial crisis over the past year and a half, and I obviously think that will remain an important subject, at least until we have a truly reformed financial system. Preventing the next financial crisis should be high on our society's priority list. But as the months and years wear on, I suspect we will see more articles like Don Peck's recent 8,000-word article in *The Atlantic*, "[How a New Jobless Era Will Transform America](#)."

Peck's article is not about what caused the recent crash and recession, but what its societal consequences will be. And the article is almost unrelentingly bleak. Even before 2008, we had already lived through a decade of stagnant median income and sluggish job growth; the recession pushed some unemployment levels, such as the underemployment rate (people out of work, working part-time for economic reasons, or too discouraged to look for work) to levels not seen since the Great Depression. It's not particularly clear where growth will come from, as manufacturing remains in decline, services are becoming increasingly outsourceable, and other countries take the lead in the most plausible major new industry (alternative energy). According to Nobel laureate Edmund Phelps, "the new floor for unemployment is likely to be between 6.5 percent and 7.5 percent (for several reasons, including "a financial industry that for a generation has focused its talent and resources not on funding business innovation, but on proprietary trading, regulatory arbitrage, and arcane financial engineering").

The societal implications that Peck sees are worse than the mere numbers would imply. Young people who graduate into recessions never catch up with cohorts around them that graduate into better economic conditions, partly due to risk aversion, partly because they move up more slowly and get tagged as underperformers. Unemployment also changes people:

"Krysia Mossakowski, a sociologist at the University of Miami, has found that in young adults, long bouts of unemployment provoke long-lasting changes in behavior and mental health. 'Some people say, "Oh, well, they're young, they're in and out of the workforce, so unemployment shouldn't matter much psychologically,'" Mossakowski told me. 'But that isn't true.'"

The effects of unemployment go beyond, and last longer than, not having money.

“Andrew Oswald, an economist at the University of Warwick, in the U.K., and a pioneer in the field of happiness studies, says no other circumstance produces a larger decline in mental health and well-being than being involuntarily out of work for six months or more. . . . Only a small fraction of the decline can be tied directly to losing a paycheck, Oswald says; most of it appears to be the result of a tarnished identity and a loss of self-worth.”

Some of the results show up quickly: “Last March, the National Domestic Violence Hotline received almost half again as many calls as it had one year earlier; as was the case in the Depression, unemployed men are vastly more likely to beat their wives or children.”

I think this means that we need to think of employment not merely as a determinant of GDP, but as an independent good in itself. Furthermore, there are sound economic reasons why we should care not just about the overall unemployment level, but about unemployment levels in specific sub-groups (such as men in inner cities), since unemployment has obvious negative externalities.

The recession may also be reinforcing the long-term trend toward inequality in American society. Recessions typically reduce income inequality in the short term, since the rich gain much of their income from investments, which drop faster than wages in a market crash. But the tougher labor market could increase the advantage that people have coming from the upper class: “Princeton’s 2009 graduating class found more jobs in financial services than in any other industry,” Peck reports.

My initial thought was that the financial crisis and recession might have a salutary effect because the middle class, faced with serious economic insecurity, might start worrying more about economic security (and identifying more with the poor and working class), instead of thinking that individual initiative alone would make them rich. I still think this is possible. Unfortunately, it seems to be unlikely. Peck cites economic historian Benjamin Friedman, who “argues that both inside and outside the U.S., lengthy periods of economic stagnation or decline have almost always left society more mean-spirited and less inclusive, and have usually stopped or reversed the advance of rights and freedoms.” The mechanism for this is simple: although some people may react to economic insecurity by realizing that their interests lie with labor

rather than capital, other people will react by blaming their misfortune on immigrants, or minorities, or Jews, or gays, or — this being America — the government.

The only solution, says Peck, is a making “the return to a more normal jobs environment an unflagging national priority.” A more normal jobs environment seems like the bare minimum of a solution to me, and he would probably agree. But even that represents a shift from our current political center of gravity, where people think the medium-term deficit is a bigger problem than jobs.

By James Kwak

Senior Goldman Adviser Criticizes Greece – Without Disclosing His Goldman Affiliation

Simon Johnson | 15 Feb 2010

By Simon Johnson

Otmar Issing, a former senior European Central Bank official, came out strongly today against any kind of rescue package for Greece ([FT op ed](#); [Bloomberg report](#)).

He hits hard to the core of the issue:

“Financial assistance for countries that violated the terms of their participation in EMU [European Monetary Union, i.e., the eurozone] would be a major blow for the credibility of the whole framework.”

Unfortunately, Mr. Issing’s article (and the subsequent coverage) neglected to mention that he is an adviser to Goldman Sachs (see also the [FT archives](#)). This is a major issue for three reasons.

1. Goldman, we know now, was intimately involved in the deal(s) that allowed Greece to violate the terms of its participation in EMU. It is possible – but not yet confirmed – that the entire nefarious swap arrangement in 2001 was Goldman’s idea. This would be beyond being the equivalent of helping people dodge their taxes; this is actively encouraging your clients to undermine the basis of civilized society. Following Mr. Issing’s logic, which seems sound, Goldman played a major role in undermining the eurozone.
2. Goldman is currently presumed to have a stake in Greek government securities, given its recent and ongoing relationships with that country. It looks very much like Mr. Issing may be talking Goldman’s book, whether he realizes it or not.
3. Presumably Mr. Issing will be able to reassure someone that there was nothing improper about his article today. But who exactly has jurisdictions over such issues – for a US bank holding company operating in another country? Is this a matter for the Securities and Exchange Commission in Washington or the European Commission in Brussels or the German government or someone else? Where is the Federal Reserve – Goldman’s primary supervisor – on such issues, which pertain to global financial

instability? Welcome to the scary and essentially unsupervised world of international banking.

Mr. Issing and Goldman Sachs will no doubt soon issue a detailed explanation regarding his exact involvement in and knowledge of all transactions and positions related to Greece.

Hopefully, the Financial Times, Bloomberg, and other news organizations will amend their coverage to reflect Mr. Issing's affiliations – and also ask more pointed questions about potential conflicts of interest in the future.

The scope, reach, and influence of Goldman Sachs today are unprecedented. Thinking in terms of the broader global economy – and our own struggling recovery – is this a good thing?

At the very least, we need a great deal more transparency and disclosure regarding everything said or done by anyone linked to Goldman in any fashion.

Jeff Sachs on the Deficit

James Kwak | 16 Feb 2010

By James Kwak

Jeff Sachs:

“Policy paralysis around the US federal budget may be playing the biggest role of all in America’s incipient governance crisis. The US public is rabidly opposed to paying higher taxes, yet the trend level of taxation (at around 18% of national income) is not sufficient to pay for the core functions of government. As a result, the US government now fails to provide adequately for basic public services such as modern infrastructure (fast rail, improved waste treatment, broadband), renewable energy to fight climate change, decent schools, and health-care financing for those who cannot afford it.

“Powerful resistance to higher taxes, coupled with a growing list of urgent unmet needs, has led to chronic under-performance by the US government and an increasingly dangerous level of budget deficits and government debt.”

That’s part of a longer article, “[Obama in Chains](#),” on the challenges presented by political polarization. Sachs seems generally sympathetic to Obama, although he criticizes him for his pledge of no new taxes on the “middle class” and ruling out a value-added tax.

Unfortunately, Sachs isn’t long on practical solutions: he prescribes an end to the Iraq and Afghanistan wars, increased taxes, and lobbying reforms. But that’s in part because the problem is hard to solve.

Fallout From Goldman-Greece Affair Widens: Impact On The European Central Bank

Simon Johnson | 16 Feb 2010

By Simon Johnson

As controller of the euro, the European Central Bank (ECB) wields great power in Europe and has a wide global reach. The race to become the ECB's next president – with a term that starts next year – has been intense and hard fought. The final selection is down to two men: the ultra hawkish Axel Weber, head of the Bundesbank, who sees inflation dangers at every turn; and the relatively more moderate Mario Draghi, head of the Bank of Italy, chair of the Financial Stability Board, and experienced international economic diplomat.

Unfortunately for those hoping that Draghi could still prevail, he is also formerly senior management at Goldman Sachs and serious questions are emerging regarding what he knew and did during Goldman's alleged "let's help Greece circumvent EU budget rules" phase in the early 2000s.

Specifically, Draghi joined Goldman Sachs in January 2002, after a distinguished public service career – including 10 years in a key position (Director General) at the Italian Treasury. His formal titles were Managing Director, Vice Chairman of Goldman Sachs International, and member of the "Group's Commitment Committee"; his job, according to Goldman's press release, was to "help the firm develop and execute business with major European corporations and with governments and government agencies worldwide."

Did this involve Greece?

A German foreign affairs spokesman said yesterday, with regard to the Goldman-Greece transactions,

"Goldman Sachs broke the spirit of the Maastricht Treaty, though it is not certain it broke the law"

and

"What is certain is that we must never leave this kind of thing lurking in the shadows again."

Presumably this means that Mr. Draghi will have to answer a series of embarrassing questions, should he wish to continue pursuing the presidency of the ECB, along the following lines.

1. Was he aware of the Goldman-Greece deal(s)? (Given that he was involved in management for Goldman – and that these deals reportedly made \$300m for the firm – he surely knew what was going on.)
2. Did he attempt to stop it or prevent further such deals? If not, why not?
3. Does he approve of such deals today? If not, why did he approve earlier in the decade?
4. Did he or his associates engage in any such transactions for Italy when he was at the Ministry of Finance?
5. Are there are other Greece-type deals, involving other EU countries (or anyone else), that he would care to discuss in detail?

These questions and many more will be asked by the German authorities, at first quietly and if necessary then out loud – both because they are (with good reason) upset at the prospect of bailing out Greece, and also because they insist Mr. Weber should run the ECB.

You can pretty much count Mr. Draghi out of the running for the ECB job, and it would not be a surprise if he soon steps down from chairing the Financial Stability Board.

Being associated with Goldman Sachs is now beyond awkward. For someone aiming high in the public sphere, work experience at the top levels of Goldman is fast becoming a toxic asset.

Greg Mankiw on the Deficit

James Kwak | 16 Feb 2010

By James Kwak

Broken record alert: Another post on the deficit ahead. Wouldn't you rather look at funny pictures of cats? Why do I keep writing these? (Hint: The other side keeps writing them.) You have been warned.

Greg Mankiw, noted economics textbook author and former chair of Bush 43's Council of Economic Advisers, has an op-ed on the deficit that is relatively sensible by the standards of recent debate. He points out that modest deficits can be sustainable, that taxes will probably need to go up, and that a value-added tax is a plausible option. He also points out that Obama's projections are based on optimistic economic forecasts that very plausibly may not pan out, and that Obama's main deficit-reduction strategy is to kick the problem over to a deficit-reduction commission, which are valid criticisms.

Unfortunately, his bottom line seems to be throwing more rocks at President Obama, under the general Republican principle that since he's the president, everything is his fault:

"But unless the president revises his spending plans substantially, he will have no choice but to find some major source of government revenue. Ms. Pelosi's suggestion of a VAT may be the best of a bunch of bad alternatives. Unfortunately, in this new era of responsibility, the president is not ready to face up to the long-term fiscal challenge."

Mankiw, not I, brings up the comparison between Bush 43 and Obama:

"From 2005 to 2007, before the recession and financial crisis, the federal government ran budget deficits, but they averaged less than 2 percent of gross domestic product. Because this borrowing was moderate in magnitude and the economy was growing at about its normal rate, the federal debt held by the public fell from 36.8 percent of gross domestic product at the end of the 2004 fiscal year to 36.2 percent three years later. . . .

"[Mr. Obama's budget] fails to return the federal government to manageable budget deficits, even as the wars wind down and the

economy recovers from the recession. According to the administration's own numbers, the budget deficit under the president's proposed policies will never fall below 3.6 percent of G.D.P. By 2020, the end of the planning horizon, it will be 4.2 percent and rising."

What's missing from this comparison? First, the economic growth of 2005-2007 was at best a mixed blessing, as we now know, driven by an unsustainable and ultimately catastrophic credit bubble. Second, and more importantly, the comparison leaves out the long-term trend . . . wait for it . . . Medicare.

Here's my favorite chart again, from the 2008 CBO Budget and Economic Outlook.

In 2007, Medicare, Social Security, and Medicaid cost 8.9 percent of GDP (see Table 3-1). By 2018, they were already projected to grow to 10.8 percent of GDP; extrapolating forward at constant growth rates, by 2020 they would grow to about 11.3 percent — an increase of 2.4 percentage points over 2007. That, in one number, is the difference between Bush 43 and Obama. (Ongoing patches to the AMT — something that Obama includes in his projections that Bush did not — also grow to \$150 billion by 2018, or another 0.7 percent of GDP.)

Did Bush 43 do anything about this looming problem? No, because one conservative aspiration since Ronald Reagan has been to crimp government by crippling its finances ("starving the beast"). If Bush had actually reduced the size of government to match his tax cuts, in true conservative fashion, we would face less of a long-term deficit problem now.* But whether by accident or design, it turned out to be politically advantageous to kick the problem down the road and therefore make it harder for his successor to govern.

Now, this doesn't change the fact that it's Obama's problem now, and it's his responsibility to do something about it. But Obama realized that the long-term deficit is a health care problem, while Mankiw doesn't even use the word "health" in his op-ed on the deficit. If we don't slow the growth of health care costs, there is no real solution to the deficit problem; the only way out from the budget perspective will be slashing Medicare, but that doesn't solve the problem — it just shifts it onto individuals. And Obama spent much of the last year pushing for health care reform with major cost-cutting components,** attracting support from some Republican health experts (though not from any Republican

Congressmen). Now, it would be meaningful to criticize Obama for having the wrong ideas about how to control health care spending, as a few Republicans have done. But to say he's not up to the challenge without mentioning health care misses the real point.

Still, it's true that Obama could put forward a more aggressive deficit reduction plan. If I were king, my plan would include modest increases in the Medicare eligibility age, a whole bevy of health care cost reduction initiatives, modest tax increases (pushed out into the future and made contingent on economic recovery) such as eliminating the cap on the Social Security tax and reinstating the estate tax, and bigger tax increases that would kick in if health care cost savings failed to materialize. But in our current political climate, that would be political suicide for any president and would have zero chance of passage. I'm skeptical about the deficit commission, too, but we have collectively backed ourselves into a position where neither party can afford to even propose the necessary steps on its own.

The political problem is that there's no politically palatable way to solve the long-term deficit problem. The Republican strategy, after (almost) killing health care reform, is to attack Obama for not having a long-term solution, daring him to propose one so they can then attack him for raising taxes. Yes, that's the way the game is played. That doesn't change the fact that it's a game.

* Bush did make an attempt to reform Social Security. But even if we assume he had managed to stop the growth of Social Security completely, the growth in Medicare, Medicaid, and the AMT fix would by themselves account for the difference between the 2005-2007 deficits and the projected 2020 deficit.

** The Senate health care bill only reduces the deficit by a little by year ten, because the CBO gives it very little credit for its cost-cutting measures, particularly the delivery system reforms. It is fair for the CBO to give those reforms little credit, since they are unproven. But it is also important to remember that there is no proven way to reduce health care costs (Paul Ryan's plan reduces government expenditures reliably, but it is no more proven to reduce actual health care costs), so the *only way* to have any chance to reduce health care costs is to undertake the kind of experimentation proposed by the Senate bill.

The Day Google Became Just Another Company

James Kwak | 16 Feb 2010

By James Kwak

Not the day they launched Google Buzz, but the day that Google Buzz product manager Todd Jackson responded to legitimate privacy concerns by writing this piece of meaningless corporate PR spin worthy of, well, any other company out there: “Google remains completely committed to freedom of expression and to privacy, and we have a strong track record of protecting both.”

Doing Discounting Wrong

James Kwak | 16 Feb 2010

By James Kwak

Ezra Klein focuses on this passage from John Judis's review of regulatory policy in the Bush and Obama years:

“Bush stopped weighing the costs and benefits of deregulation and issued an executive order allowing OIRA to intercede before agencies made their initial proposals, thereby providing industry lobbyists with a back door to block regulations. OIRA also instructed agencies to discount the value of future lives in constructing cost-benefit analyses by 7 percent a year, so that 100 lives in 50 years would only be worth 3.39 current lives. (Such logic can be used by conservatives to argue that the present cost of regulating greenhouse gases outweighs the future benefits of stopping climate change.)”

There is a normative argument against valuing lives in cost-benefit analysis; some people think it's just wrong. I don't agree with that; I think that in practice, you either value lives implicitly or you do it explicitly, and so you might as well do it explicitly. And for what it's worth, the practice of valuing lives is firmly entrenched in our legal system; the amount you pay in damages if you kill someone negligently depends primarily on that person's future earning potential, and also on the monetary value of the benefits that other people gained from his or her life.

There is another argument against discounting future lives, however. The basic premise of discounting is that money in the future is worth less than money today. This has two components. One is the time value of money: \$100 with certainty one year from now is worth about \$99 today, because you can invest \$99 in an FDIC-insured account at about 1% and get back \$100 in a year. The second is risk: Future events are not certain, and the less certain they are to occur the less valuable they are to you.

Does this apply to lives, however? If a regulatory agency says, this rule will cost industry \$1 billion in present-value terms, but it will save 1,000 lives twenty years from now, is that any different from saying it will save 1,000 lives today? That seems wrong to me; you can't take, say, 900 lives now, put them in the bank, and get back 1,000 lives in twenty years.

I can see the counterargument, though: once you've agreed to value lives in monetary terms, you can translate those 1,000 lives twenty years in the future into some amount of money twenty years in the future, and you can discount *that* back to today.

But if we're going to do that, let's at least do it right. A discount rate of 7 percent?

I assume that's a real discount rate, not a nominal one, since anyone doing this kind of spreadsheet over decades would use real terms to avoid inflation uncertainties.* A discount rate of 7 percent means that 100 lives in ten years are worth roughly 50 lives today. Is that justified?

By the time value of money theory, the government (or industry) could put aside money in an account today and use it to pay benefits to the survivors of dead people at some point in the future when the deaths occur. But if we're going to use that logic, we need to look at the risk-free rate of return. Over the last five years, the ten-year Treasury yield has generally been between 4 and 5 percent. Call that 4.5 percent. Inflation has been in the low 2 percent range, so at best this is a risk-free return of 2.5 percent.

But it gets worse than that, because the real value of lives is continually increasing. This is because GDP grows faster than inflation, and faster than inflation plus population growth. The rest of GDP growth is productivity growth, which means that people produce more and, on average, they earn more (even if the median workers doesn't). Since the legal value of a life is primarily based on future income, this means that the real value of a life increases roughly with productivity. Productivity growth runs at about 2% per year. So if you are getting 2.5 percent on your risk-free investment, 2 percentage points of that just goes to make up for the fact that the people your policy is killing are getting more expensive, which means your discount rate should be 0.5 percent. (The numbers don't quite add up here, since I think population growth is actually around 1% per year. So let's say your discount rate should be 1 percent — still a lot less than 7 percent.)

But that's just the time value of money — shouldn't we also be discounting for risk? But I think that's wrong. In the corporate finance model, you look at the volatility of the expected cash flows. Let's say you have an investment that has an expected return of \$1 million in ten years with some probability distribution around \$1 million. The textbook says you should adjust your discount rate based on that probability distribution — the wider the distribution (the riskier the investment), the

higher the discount rate. This makes sense because of basic risk aversion. In the financial context, the more risky the project, the higher the expected return has to be to justify it.

Now let's translate this into lives. Say you have a policy that is likely to kill 1,000 people in ten years, but it might kill more or it might kill fewer. Should that be counted as fewer lives than a policy that is certain to kill 1,000 people in ten years? In other words, does risk aversion mean that we should *prefer* policies that kill variable numbers of people to policies that kill certain numbers of people? That doesn't make sense to me, and hence discounting for risk doesn't make sense to me in the lives context.

That leaves us with a discount rate of 1 percent, not 7 percent. And instead of 3.39 lives today, you get 60.80 lives today. That's a big difference.

(If the 7 percent is nominal instead of real, you don't deduct inflation from the 10-year Treasury yield; however, then the value of lives grows because of both productivity and inflation, so you end up roughly in the same place.)

* It might make sense to use nominal terms if some of your future values were fixed in nominal terms. But in a situation like this, where *all* of your future values are fixed in nominal terms, I can't see any reason to do the calculations in nominal terms.

Why Is Wal-Mart Paying Retail Prices?

James Kwak | 17 Feb 2010

By James Kwak

Ted K. points out (and comments on) Stephanie Fitch's article in *Forbes* on Wal-Mart's 401(k) plan. The crux of the matter is that Wal-Mart seems to have done a lousy job creating a good 401(k) plan for its employees. Until recently, it had ten funds, only two of which were index funds; the other, actively managed funds all had high expense ratios (the ones Fitch quotes are above 1 percent).^{*} More shockingly, the expense ratios paid by plan participants were *the same* as the expense ratios paid by individual investors in those mutual funds. It didn't even pool its employees' money together to get institutional investor rates. The irony, of course, is that Wal-Mart is the world's best, most powerful negotiator when it comes to getting low prices for the stuff it sells, yet it exercised no negotiating power in getting low prices for its employees — even though it had \$10 billion in assets to swing like a club.

One allegation of the current lawsuit is that Merrill Lynch, which administered the plan, may have chosen funds for the plan because of (legal) kickbacks it was getting from the fund managers. In other words, Merrill was pushing specific funds onto Wal-Mart employees because it was effectively getting sales commissions for those funds. This is classic banking behavior, of course, but it's a bit of a mystery to me why Wal-Mart would put up with it; since it's just as easy for Wal-Mart to create a good 401(k) plan for its employees as a bad one, why did it create a bad one? (I don't actually think Wal-Mart would actively go out of its way to screw its employees if it didn't benefit it some way.)

I say it's classic banking behavior, because of course banks will try to sell you products that give them bigger profits; it's their interests they have in mind, not yours. The basis of the lawsuit, however, is that Wal-Mart violated its fiduciary duty to plan members under ERISA. Unfortunately, the fiduciary duties under ERISA seem (as far as I can tell on a very cursory reading) to be pretty flimsy, having to do mainly with disclosure. In other words, you can create a lousy plan for your employees; you just have to tell them all about the plan so they can figure out that it's lousy. (And in any case, since most employees are effectively captives of their employers, there's nothing they can do about it, anyway.)

401(k)s are in many ways a feeble substitute for traditional defined-benefit pensions. Among other things, unless you get an employer match, it's all your money — your employer isn't contributing anything. The tax deduction you get from a 401(k), like all tax deductions, is valuable in direct proportion to your marginal tax rate and the amount you are able to put aside, meaning that it is extremely regressive. But still, it's a modest benefit for working people (and a better benefit if there's an employer match). However, like all investments, the tax benefits can be rapidly swallowed up by fees.

One hundred years from now, people will look back and say we were all suckers for paying expense ratios of over 1 percent to fund managers who generally fail to beat the market. Unfortunately, we will all be dead before then, and in the meantime we'll be paying those fees.

(This is what Wal-Mart had to say about the issue: "We are proud to provide a high-quality, innovative retirement plan to help more than one million of our Wal-Mart associates prepare for the future." Reminds me of something Google recently said.)

* I don't think having a small number of funds is bad in itself. Too much choice can be counterproductive, especially if some of the choices are bad; it's better to have three cheap funds than to have three cheap funds and seven expensive ones.

Banker for the CFPA

James Kwak | 17 Feb 2010

American Banker is running an [article by Bill Wade](#) (subscription required, but free trial available), a former banker . . . explaining why the banking industry should be in favor of a Consumer Financial Protection Agency. Wade repeats many of the arguments made by consumer advocates such as Elizabeth Warren:

“A Consumer Financial Protection Agency can be the vehicle that restores consumer confidence in our products, our services and our institutions. The customers we serve will always need credit and other banking products . . . What they want is simple, clearly explained products and the comfort that someone is looking out for their best interests when financial products are developed and marketed. . . .

“In every existing agency, consumer protection is a secondary or tertiary responsibility, after safety and soundness. Consequently, it is often a regulatory afterthought.

“If we expect attention to be paid to consumer protection and product simplification these functions must be consolidated into a functional entity with rulemaking and enforcement authority. . .

.

“For a good portion of my banking career, I have been involved with products registered under the supervision of regulators who continually examine, write rules and look for wrongdoing. It has not always been easy, but my experience has taught me that vigilant, well designed regulations and agencies are the best structure for protecting me as a businessman and the consumers I serve.”

Wade’s main request is that the industry work with Congress to “improve” the CFPA rather than simply dig in its heels and try to kill it. I’m not thrilled about more rewriting of the legislation by the banking lobby. It’s already been “improved” plenty in the House, which took out the plain-vanilla requirement and also exempted the vast majority of banks from direct CFPA examinations (the CFPA will set the rules, but examinations will be done by the primary safety and soundness regulator). But practically speaking it’s better than all-out opposition.

And Wade is right: the industry will be better off if customers actually trust it, because otherwise they will switch into cash, which doesn't help the banking industry.

The problem is that the Republican Party, traditionally the political vehicle of the banking lobby, has its own, separate reasons for wanting to kill the CFPA. My guess is that even if the ABA and the ICBA went to the Republican leadership (Michael Steele? Mitch McConnell? Richard Shelby? John Boehner? Sarah Palin? Is that an oxymoron?) and asked for a constructive attitude toward the CFPA, the Republicans would turn them down, because they see more political value in following the Frank Luntz line and demonizing regulation.

Gaming the PPIP?

James Kwak | 17 Feb 2010

By James Kwak

A couple of weeks ago, Yves Smith picked up on the story that the TARP Special Inspector General is investigating suspicious trades in connection with the Public-Private Investment Program. When PPIP was announced almost a year ago, there was widespread speculation about how banks and other private investors could take advantage of the program to unload toxic securities onto taxpayers (technically speaking, onto investment funds containing some private money, some public money, and a lot of non-recourse financing from the government). That story more or less faded away because PPIP never really amounted to much; banks apparently decided they were better off sitting on their toxic assets, counting on favorable accounting rules and regulatory forbearance, instead of selling them.

Here's the relevant section from the SIG-TARP report (p. 141):

"The PPIF management company in question operates both a PPIF and one or more non-PPIF funds that invest in similar securities (i.e., mortgage-backed securities ('MBS')). In the case of this fund management company, the same person is the portfolio manager for both the PPIF and the non-PPIF fund. In late October, the portfolio manager directed that a particular MBS from the non-PPIF fund be sold after the security — in this case a residential MBS — had been downgraded by a rating agency. According to the company, multiple bids were received, and a quantity of the security was sold to a dealer. Within minutes of the sale, however, the same portfolio manager purchased, for the PPIF, the same amount of the same security from the dealer at a slightly higher price. Later in the day, the portfolio manager bought more of the security for the PPIF from the dealer at the original price.

"The management company involved (the identity of which is not being disclosed at this time pending SIGTARP's investigation) asserts that there was nothing inappropriate about these trades, and Treasury has concluded that the trades did not violate PPIF rules. The facts, however, give rise to difficult questions. Was the initial purchase really arm's length, or was the

dealer aware that the portfolio manager was prepared to repurchase the securities immediately? How can a manager conclude that it is wise to sell a security at one price but then almost simultaneously repurchase the same securities at a higher price? Were these trades designed to push the risk of this downgraded security from the private, non-PPIF fund onto the taxpayer-supported PPIF?"

I wouldn't necessarily assume wrongdoing. For one thing, the fund manager is just a fund *manager*, meaning he makes fees (based on assets under management and performance) from both the PPIF and the private fund. So arguably, shifting losses from one fund to another doesn't help him that much. Of course, there are various scenarios under which it would benefit him: the fees from the private fund could be higher; one fund could have profits from which he gets a cut while the other may not; he could have *his* money in the private fund but not in the PPIF; he could have a nudge-nudge wink-wink agreement with the private investors; and so on.

More on Mankiw

James Kwak | 17 Feb 2010

By James Kwak

I recently criticized Greg Mankiw's New York Times op-ed. I like the post on his blog better (hat tip Tyler Cowen). Basically he says that if conservatives on the deficit commission want to make the commission work (a big if — see my previous post), they “will have to agree to higher taxes as part of the bargain.” In exchange, they should ask for the following:

1. *Substantial cuts in spending.* Ensure that the commission is as much about shrinking government as raising revenue. My personal favorite would be to raise the age of eligibility for Social Security and Medicare. Do it gradually but substantially. Then index it to life expectancy, as it should have been from the beginning.
2. *Increased use of Pigovian taxes.* Candidate Obama pledged 100 percent auctions under any cap-and-trade bill, but President Obama caved on this issue. He should renew his pledge as part of the fiscal fix. A simpler carbon tax is even better.
3. *Use of consumption taxes rather than income taxes.* A VAT is, as I have said, the best of a bunch of bad alternatives. Conservatives hate the VAT, more for political than economic reasons. They should be willing to swallow a VAT as long as they get enough other things from the deal.
4. *Cuts in the top personal income and corporate tax rates.* Make sure the VAT is big enough to fund reductions in the most distortionary taxes around. Put the top individual and corporate tax rate at, say, 25 percent.
5. *Permanent elimination of the estate tax.* It is gone right now, but most people I know are not quite ready to die. Conservatives hate the estate tax even more than they hate the idea of the VAT. If the elimination of the estate tax was coupled with the addition of the VAT, the entire deal might be more palatable to them.

I would agree with #1 (at least with a gradual increase in the eligibility ages, plus indexing, although the indexing should be lagged so people have some predictability) and #2.

It's harder to give a blanket endorsement to the others, because they raise a number of issues that are interconnected: What taxes would you raise to compensate for elimination of the estate tax? How big would the VAT be? Mankiw has previously said he would be open to a VAT that was made progressive via a rebate to poor people — I would agree to that much sooner than to a VAT without such a rebate. Also, Mankiw prefaced this list by saying conservatives would have to agree to higher taxes. If he wants to cut income tax rates and eliminate the estate tax, just what taxes would he agree to make higher? Is he saying the VAT should not only make up for those cuts, but add additional tax revenue on top of that?

But if I were a Democratic representative on the deficit commission, I would certainly be willing to talk about those issues.

Just thinking: What if they put Mankiw and Krugman on this commission?

What's a Populist?

James Kwak | 18 Feb 2010

By James Kwak

As Simon has previously discussed, “populist” has become a smear, epitomized by David Brooks’s frankly offensive attempt to classify populism as an “organization of hatreds” akin to racism and sectarianism. Brooks asserts, without support, that populism amounts to “simply bashing the rich and the powerful,” “class war,” “random attacks on enterprise and capital,” and a “zero-sum mentality” — proving that ideologies are easy to bash when you assume their properties.

“Populism” has been rolled out repeatedly over the last year to marginalize people who criticize Wall Street and the financial oligarchy as angry, know-nothing, Luddite, Trotskyist, ungrateful, envy-filled people who don’t understand the modern world and would return us to a barter economy. A search for “Krugman populist” returns 1.7 million hits. (“Simon Johnson’ populist” returns 180,000.) So I was pleased to read Louis Uchitelle’s New York Times article that begins with this clever introduction:

“Put aside for a moment the populist pressure to regulate banking and trading. Ask the elder statesmen of these industries — giants like George Soros, Nicholas F. Brady, John S. Reed, William H. Donaldson and John C. Bogle — where they stand on regulation, and they will bowl you over with their populism.”

The substance of the article is that these prominent financial industry veterans — a billionaire hedge fund manager, a former Republican treasury secretary (and investment banker before that), a former Citigroup CEO, a former Republican head of the SEC (and investment banker before that), and the founder of one of the largest mutual fund companies — all support financial sector reforms that go at least as far if not beyond those proposed by Paul Volcker (another reform advocate that few columnists dare to call a populist). Brady, for example, is open to the idea of not just banning proprietary trading by government-insured banks, but banning securities trading altogether by such banks. This should come as no surprise — he was saying similar things a year ago.

Of course, one could argue that these distinguished (and very rich) men are not actually “populists” — they are sensible, experienced advocates of reform who seek closer regulation of the financial industry because they want to create a stable financial system that promotes economic growth. Since “populist” has no independent meaning, you can reserve it for the people you don’t like and find another word (“reformer”?) for the people you can’t easily write off.

Whatever. The more hedge fund legends, former senior government officials, and financial sector titans come out against the modern version of Wall Street and in favor of reform, the harder it becomes to equate criticism of Wall Street with “random attacks on enterprise and capital.”

Did the Stimulus Help?

James Kwak | 18 Feb 2010

By James Kwak

This could be a midsize political battle in the run0up to the midterm elections, as discussed by *The New York Times*. The positions on both sides are too obvious to warrant repeating. If I recall correctly, the Obama administration hurt itself by underestimating the course of future unemployment a year ago when it passed the stimulus (most people were making the same mistake at the time), so now if you compare actual unemployment against original projections it looks like the stimulus had no impact. But that was a forecasting error and has nothing in itself to do with the stimulus itself.

Menzie Chinn has an overview post on the debate in which he argues that, at least from the standpoint of economists, it's hardly a debate: the stimulus worked.

He points out that leading private-sector economic consulting firms are crediting the stimulus with significant impacts on GDP growth and employment. Here's the money chart (originally from the Times):

Chinn discusses the types of models used to generate those forecasts, and competing models used by a few academics that yielded different results. He also points out that the CBO also estimates significant growth and employment impacts. If you want to pursue the matter further, he links to a couple of contrary arguments.

Of course, none of this will matter in the end because, as someone (Barney Frank?) said, you can't get elected saying things would have been even worse without you. Unemployment will still be high in November and the Republicans will blame it on Obama. Voters aren't going to believe macroeconomic models, don't realize that unemployment is a lagging indicator, and will (with a little justification) think that Obama could have done more to create jobs.

The Systemic Risk Solution

James Kwak | 18 Feb 2010

By James Kwak

From The New York Times: A council of regulators chaired by the treasury secretary, with the Fed chair or his designate as the vice chair. At present, that would be Tim Geithner and Ben Bernanke.

I wouldn't ordinarily write a whole post about this (if I just want to link to something, I try to use Twitter), but I had to point out this line by Calculated Risk:

"I can just imagine a council in 2004 and 2005 led by ex-Treasury Secretary John Snow with Alan Greenspan as Vice Chair. Yeah, that would have worked well ..."

Greece Should Approach The IMF

Simon Johnson | 18 Feb 2010

By Simon Johnson

European Union pressure is growing for Greece to “do the right thing” – which means, to the EU’s leaders, a massive and sudden cut in the Greek budget deficit. Greece, without doubt, has gotten itself into a fine mess; still, it is now time for the Greek government push back more effectively.

Fuming at EU arrogance will accomplish nothing. And, while global investment banks may have helped hide the evidence, it seems unlikely they actually designed the great blunder of eurozone admission (and broken Greek promises). It’s time to stop blaming others and get crafty.

Greece should open a semi-official channel to the IMF and talk discretely about taking out a loan.

This is not an anti-Greek suggestion. The IMF has changed a great deal over the past 10 years – learning lessons and developing new ways of thinking. (For more detail, [see my current Project Syndicate column](#).) Today’s IMF would give Greece a much more reasonable deal than would the EU acting alone.

But the main reason to approach the IMF is that this, if done properly, would drive the EU nuts in a most productive manner.

The Germans really do not want more IMF pressure to ease up on European Central Bank monetary policy or – heaven forbid - to engage in some fiscal expansion (or other increase in domestic demand). The Germans want to export their way out of recession, and the devil take the hindmost.

And President Sarkozy absolutely does not want the current IMF Managing Director - Dominique Strauss-Kahn - to do anything that can be presented as a statesman-like contribution to the world. Strauss-Kahn is a contender for the French presidential election in 2012, so you can see how that works. (Aside: strictly speaking, according to IMF rules, Strauss-Kahn should step down from the Fund; but he is too wily a politician to let anyone push him out at this moment.)

By approaching the IMF, Greece will get a better deal from the European Union. Our baseline view is still that the IMF’s role will be only “technical”, but behind the scenes the prospect of greater IMF

engagement (and even a standby loan) is a powerful card that Greece should threaten to play.

Capital Controls Again

Simon Johnson | 19 Feb 2010

By Simon Johnson

Adair Turner, head of the UK's Financial Supervisory Authority, has developed a flair for pushing the official conversation on banking forward.

He spoke in favor of a tax on financial services, long before that was fashionable. This idea has been picked by both the UK and US governments – and in some amended form is likely to emerge from the G20 intergovernmental summit process later this year.

Turner also pointed out that much of financial innovation is not actually socially useful – and may, in some instances, be profoundly dangerous. For a while, it seemed that his voice on this point might be lost in the wilderness. But then President Obama launched the Volcker Rules, which essentially attempt to rein in certain forms of risk-taking (and arguably innovation) by very big banks.

Now Adair Turner is at it again, this time in the 14th Chintaman Deshmukh Memorial Lecture, delivered at the Reserve Bank of India in Mumbai earlier this week.

Turner lays out a more integrated – and skeptical – view of modern finance than we have heard from him before. He also delves into new issues, of obvious interest to his hosts and – if we are thinking straight – to the rest of us: What do our recent financial crises imply for emerging markets?

He points out that the so-called Asian financial crisis of 1997-98 and the more global crisis of 2008-09 had much in common.

“... both were rooted in, or at least followed after, sustained increases in the relative importance of financial activity relative to real non-financial economic activity, an increasing “financialisation” of the economy.”

The big point here is that the standard thinking about finance is wrong. More financial development (e.g., an increase in the size of bank deposits or credit relative to GDP) is not necessarily a good thing. To be sure, “financial repression” in the traditional poorer country fashion – with interest rates held low, often below inflation – was never appealing as it discourages savings, and should not now be a goal.

But allowing finance to become as big as it wants, from usual market processes, is asking for trouble. The corollary is that “financial liberalization” – just get out of the way, as Alan Greenspan used to argue, and let markets do their thing – can become very dangerous.

This is true for the United States – at one level the last 30 years have been a series of misguided and excessive financial liberalizations. But it is also true for other countries, presumably at all income levels.

Much of what Turner is arguing on these issues is not new – as he acknowledges, the general points have been made eloquently before, in various fashion, by scholars such as Jagdish Bhagwati (in broad terms) and Arvind Subramanian (in specific form, with numerous co-authors).

But Turner has a knack for bringing officials with him. He is ahead of the intellectual curve, but not so far divorced as to seem out of touch or irrelevant. And where exactly is he going, on this occasion?

Turner’s language is nuanced but the thrust of his argument is clear. We should reevaluate the usual prescription that developing countries (and anyone else) should necessarily open themselves to freer capital flows.

“... the case that short term capital liberalization is beneficial is ... based more on ideology and argument by axiom than on any empirical evidence.”

“For what we saw in respect to capital flow liberalization in the 1990s (as in respect to domestic financial liberalization in developed countries) was the assertion of a self-confidence ideology which also happened to be in the direct commercial interest of major financial services firms with powerful political influence in the major and developed economies and in particular in the US.”

Turner stops short of taking the complete Bhagwati-Subramanian position. Even the most courageous financial regulator on the planet is apparently not yet ready to endorse restrictions on capital flows between countries – presumably, the lobbying pressure on this point is still too intense.

But this is definitely the direction in which Turner is moving – and has already moved – the debate. Restricting capital flows will imply changes in many other aspects of how we organize our economy, including our fiscal deficit (as a great deal of the short-term capital flows around the world is into and out of US government securities) and what we rely on

to sustain growth (as the US has been a big net importer of foreign capital in recent decades).

And it will have significant implications for our financial system which, in recent years, has made a great deal of easy money by moving money around the world – and, as Adair Turner continues to emphasize, has thus created serious global risks.

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

Six Questions For Axel Weber

Simon Johnson | 19 Feb 2010

By Simon Johnson

Given recent maneuverings around European Central Bank (ECB) appointments and the obvious discomfort of Mario Draghi – he carries the Goldman Sachs connection now like other people carry albatrosses – the German financial-industrial complex seems to regard Axel Weber as a “done deal” to become the new ECB president.

Such an assumption is premature. Mr. Weber, as long standing head of the Bundesbank and general German economic maestro (including, quietly, on fiscal issues), is due to face his own round of questioning – if you listen carefully, you can hear southern Europeans sharpening their arguments, and with good reason.

There are six important and difficult subject areas for Mr. Weber.

1. Who was asleep at which wheel when Deutsche Bank was allowed to become one of the most leveraged banks in the world, betting and losing heavily on subprime mortgages – among other things?
2. What exactly was Mr. Weber’s involvement in the Hypo Bank debacle? Germany likes to claim that it can regulate large banks effectively – and there is no reason to limit their size. To the rest of us, it seems like Germany can’t even regulate and control relatively small banks.
3. Why does Germany continue to resist sensible proposals to increase capital requirements on banks (both at the deputy minister level and through the relentless lobbying of Josef Ackermann)? The presumption among their closest allies is that this is to hide losses – and general government culpability – in the mismanagement of German public banks (Landesbanken). Why is it reasonable to hold up the entire G20 process (and the BIS, etc), at a technical level, for what is essentially a broad form of political cover-up?
4. Why have the full results of European bank stress tests never been published? Is this because of large current and likely future losses on the balance sheets of financial institutions that fall within Mr. Weber’s remit?
5. German officials are keen to criticize the southern periphery of the eurozone, but let’s face it – eurozone monetary policy was highly procyclical (exaggerating the boom and the bust, e.g., in Spain),

and regulators looked the other way as northern/core banks extended credit to the Mediterranean and East European neighbors. The upside benefited German exporters; the downside is now being laid entirely at the door of “profligate” nations. Is this entirely fair and reasonable?

6. As Mr. Weber aspires to European-level leadership, here is the big issue. Is it his intention to manage the currency zone to suit the preferences of the core nations (i.e., Germany), while letting those on the periphery be whipped around by policies that are not suited for them? Is there anything at all that he and others take as lessons from recent experience?

More broadly, Germany and Mr. Weber have been central in building a version of the Bretton Woods fixed exchange rate system within Europe. The entire burden of adjustment is placed on deficit countries (talk to Greece); it is considered beyond the pale to even suggest that German fiscal policy may be too tight, that Germany needs to expand domestic demand, or – heaven forbid – that Germany’s intention to export its way back to growth (with a current account surplus, in their view) is not exactly a model of enlightened economic leadership.

On top of this, and unlike Bretton Woods, there is no mechanism for adjusting exchange rates within the currency union. Given what we have learned in the past two years, is this still such a bright idea?

With Draghi damaged and the Weberian model so open to question, look (or hope) for dark horses to emerge in the race for the ECB.

And don’t make the mistake of thinking that you don’t care. The broader European economy accounts for around 1/3 of world GDP, depending on how you count it. The President of the European Central Bank is the preeminent policy maker in this space.

If the growth prospects for this area remain dismal while European banks stay loosely supervised (our Axel Weber baseline), expect even more destabilizing capital flows into emerging markets – and into the United States.

Bank of Italy Defends Draghi

James Kwak | 19 Feb 2010

By James Kwak

The *Corriere della Sera*, probably Italy's most respected newspaper, relays a statement by the Banca d'Italia (Italy's central bank) that its head, Mario Draghi, had "no role" in the Greece-Goldman Sachs interest rate swaps that have been reported by *Der Spiegel* and *The New York Times*. Here are some translated excerpts from the story:

"The transaction with Greece 'was executed prior to the arrival of Draghi at Goldman Sachs,' added sources from the [Banca d'Italia*], recalling that the governor [Draghi], who has headed the Banca d'Italia since the beginning of 2006, was vice president and managing director of Goldman Sachs in London from 2002 to 2005.

"On Tuesday, the former chief economist of the IMF, Simon Johnson, in his blog but picked up by other media, drew attention to Draghi, also calling into question the transaction by Italy, while [Draghi] was serving as director general of the [Italian] Treasury. . . . But it was in light of these possible connections, to avoid misunderstandings and rumors on the past role of Draghi, that the Banca d'Italia also chose to specify, on the subject of the Italian transactions in the 1990s, that 'they had the goal of reducing the cost of the public debt and not to hide the true state of the public's accounts.'"

The article is referring to [this post](#) by Simon asking whether Draghi had any connection to the Goldman-Greece or similar transactions with other governments.

* The actual text says "Istituto di via Nazionale." The Banca d'Italia is located on the via Nazionale in Rome. This is similar to referring to the U.K. prime minister's office as "Downing Street."

Fear Mongering, Wall Street Style

James Kwak | 19 Feb 2010

By James Kwak

Jason Paez points out this [Reuters story](#) on the claim that new banking regulations will require an additional \$221 billion of capital in the industry as a whole. I would take this a little more seriously if the source for the estimate were someone other than JPMorgan Chase, or even if there were a non-JPMorgan source to back it up.

As it is, I think this counts as another “nice little economy you’ve got there” attempt at hostage-taking or, as Paez says, “a threat levied against the entire non-banking economy if we allow the ‘extreme’ case (using the article’s words) of regulation to pass.” For one thing, I don’t see how any analyst could have come up with any number, given that the regulatory proposals I have seen *have no numbers in them*. That is, they say things like “capital requirements for large firms should be higher” but don’t say how much higher. (It’s possible I missed something recent here.) So what could \$221 billion possibly be based on?

Second, there’s this gem from one of the JPMorgan “analysts”: “In order to return to similar levels of profitability as per current forecasts, we estimate that pricing on all products (retail banking, commercial banking and investment banking) would have to go up by 33 percent.” How many things are wrong with this statement? One, that Paez points out, is that the 33 percent threat *assumes* an oligopoly that is able to pass on all costs to customers. There is no magic law of economics that says that industries naturally return to some exogenously determined level of profits. (See, for example, our [most famous chart](#), on the ratio of financial sector profits to total U.S. corporate profits; there’s a better version in our [upcoming book](#).) And there is no law that says that banks’ 2007 profit levels are the ones that they are magically entitled to. Take 3/4 of those profit levels (what you get if you don’t let prices go up by 33 percent) and you are still well above long-term historical averages.

Finally, there’s a more substantive issue behind this self-interested fear-mongering. We just lived through a decade of excessive borrowing and excessive lending by a dangerously undercapitalized financial sector that resulted in a huge crash. We need more capital in the financial system. If that causes lending to drop because banks behave more carefully, then so be it. We should find a way to manage that transition as smoothly as possible (we want to avoid overcorrecting on the

downside), but we should want to get to a situation where we have a stable financial system and a sustainable amount of borrowing. That's *good*. If forcing banks to have higher capital ratios is the way to get there, that's also good.

Doom Loop, In Cartoons

Simon Johnson | 21 Feb 2010

Drawn from “The Doomsday Cycle”, joint with Peter Boone, in LSE’s Centrepiece Winter Issue (permanent/direct pdf link: [CEP centerpiece Feb 2010](#)).

I recommend the pictures – designed by the impressive team at the Centre for Economic Performance (we just did the words).

By Simon Johnson

Mark Thoma Lets Loose

James Kwak | 21 Feb 2010

By James Kwak

Yes, Mark Thoma is generally Democratic-leaning when it comes to policy. But his blog is justly popular because it presents a wide range of views through extensive quotations and relatively little editorial commentary. So I think it's revealing that he provides the following postscript to an article by Jamie Galbraith:

"Every day that goes by with unemployment higher than it needs to be means that people are struggling needlessly. People need jobs. And not at some point in the future when Congress gets around to it (if they ever do), this can't wait another day. It should have been done months and months ago.

"Congress ought to have the same urgency in dealing with the unemployment problem as it had when banks were in trouble. Collectively the unemployed are too big to remain jobless, and the millions of individual struggles among the unemployed shouldn't be tolerated. But Congress doesn't seem to be in much of a hurry to do anything about it, or give any sign that it much cares."

Chart of the Day

James Kwak | 21 Feb 2010

By James Kwak

From Peter Goodman's story about long-term unemployment in *The New York Times*.

For those wondering, U.S. population in 1982 was about 232 million; today it's about 307 million, or about 33% more.

Unemployment benefits typically run out after six months. That deadline has been extended with federal money, but I believe the extensions will expire again in the next few months.

Then there's this:

"During periods of American economic expansion in the 1950s, '60s and '70s, the number of private-sector jobs increased about 3.5 percent a year, according to an analysis of Labor Department data by Lakshman Achuthan, managing director of the Economic Cycle Research Institute, a research firm. During expansions in the 1980s and '90s, jobs grew just 2.4 percent annually. And during the last decade, job growth fell to 0.9 percent annually."

Population growth runs at about 1 percent per year (that's the average rate from 1982 to 2009, for example).

“Please Keep This Valuable Service”

James Kwak | 21 Feb 2010

By James Kwak

Here’s a letter submitted by a reader, originally from Chase, encouraging her to keep overdraft protection on her checking account.

There’s nothing particularly evil about this — banks will no longer be allowed to charge overdraft fees without your consent, and even I will concede that there are some people who might want this service, so now they have to ask for permission. Of course, it’s a pretty hard and misleading sell: they focus primarily on the issue of funds availability (deposits may not be available immediately), and they try to frighten you with “an unexpected emergency like a highway tow.” If you do get a letter like this and are not sure what it means, remember that the bank will not tell you when you are about to overdraw your account, and it will charge you \$34 each time, even multiple times per day, no matter how small the overdraft.

I was interested to note that the bank doesn’t even promise that it will cover your overdraft — it says only that it may cover your overdraft, at its discretion. I suppose this makes sense, since they don’t want to cover an overdraft for \$100,000, but couldn’t they guarantee it up to some fixed amount? I mean, if this service is supposed to give you peace of mind, how much peace of mind do you get when the bank reserves the right not to cover your overdrafts?

Of course, what banks really should do if they care about customers is come up with a way to give you a choice at the moment of purchase. Most people probably have a credit card or cash they would switch to if their checking account can’t cover their purchase, but some people might want the choice. In an ordinary competitive market, one bank would come up with such a service* and use it to take customers away from its competitors. We’ll see if that happens.

* Some people might object that this is a network issue that individual banks can’t solve. But I doubt that a little bit of creativity could not solve the problem. There must be a way for the bank to send a message back to the POS device — that’s how they reject transactions. They just need a way to get a tiny bit more information into that message, to the effect of “this transaction would overdraw your account — swipe again if you really want to do that.”

Lowering The Boom On Financial Leverage

Simon Johnson | 22 Feb 2010

This guest post is by David Moss, the John G. McLean Professor at Harvard Business School and the founder of the Tobin Project. (See his [previous guest post here](#).)

The struggle for financial regulatory reform in Washington will fail if the debate continues to focus mainly on the bookends of the crisis – the original subprime shock and the eventual federal bailout. Although both were very serious problems, even more serious was the near collapse of the American financial system that came in between.

A healthy financial system would have been able to absorb the subprime shock, like a well-conditioned fighter who's able to take a punch and remain standing. But *our* financial system, wildly overleveraged, crumpled after just one blow. If we don't fix the leverage problem, everything else will be for naught.

Over the past several decades, rising debt levels characterized just about every part of the American economy. But total debt outstanding rose particularly fast in the financial sector, surging from \$578 billion (21% of GDP) in 1980 to \$17 *trillion* (118% of GDP) in 2008. In the years leading up to the crash, moreover, financial firms increased their leverage to dizzying heights, piling ever more debt on a dangerously thin foundation of capital. Among domestic investment banks, gross leverage ratios grew from about 23-to-1 in the first quarter of 2001 to over 30-to-1 in the fourth quarter of 2007. And that's just what was visible *on* their balance sheets. Off-balance-leverage rose dramatically higher, with contingent liabilities (including AIG's notorious credit default swaps) inflating hidden leverage to truly extraordinary levels.

Greatly compounding the problem was that much of this leverage was based on very short-term debt, creating the potential for bank runs if confidence ebbed. Much of the leverage was also concentrated at firms that had grown spectacularly in a short time. Bear Stearns, for example, had grown its assets more than 10-fold from 1990 to 2007.

Unfortunately, it was the biggest (and most highly leveraged) financial institutions that played the greatest role not only in inflating the bubble on the way up but also in driving the panic on the way down. As asset prices started to fall as a result of the subprime mess, many of these super-sized financial firms had no choice but to sell – and sell massively – to keep their already thin capital base from vanishing altogether.

Had the large financial firms been better capitalized to begin with, the catastrophic fire sales that brutalized the markets in 2008 could well have been avoided, or at least kept to a minimum. But in companies that were so highly leveraged, even small losses on their overall portfolios could wipe out their capital – a prospect that left them no choice but to *intensify* their selling as the subprime turmoil deepened. Indeed, had the terrifying downward spiral not been stabilized through aggressive federal action, the nation's financial system might have collapsed altogether, greatly worsening the recession and driving unemployment even higher – and perhaps far higher – than what we've experienced so far.

What will it take to prevent such a calamity from ever happening again? We should certainly address the bookends of the crisis: common-sense regulation of consumer and mortgage lending would help to prevent another subprime fiasco; and the creation of new tools for dealing with major financial firms that fall into distress could reduce the need for another bailout. These are critical steps. But by far the most important thing we can do is make our financial system strong enough to withstand a significant shock, and that means limiting leverage, particularly at the nation's largest financial firms.

Fortunately, the House bill passed in December already contains language capping the leverage of "systemically significant" financial institutions at no more than 15-to-1. (Full disclosure: I suggested the provision, and worked with Representative Jackie Speier who shares my concern about leverage and sponsored the relevant amendment in committee.) It is now imperative that the Senate adopt this provision, or even tighten it, perhaps taking the limit down to 10-to-1.

Congress should also impose strict limits on these firms' short-term borrowing and off-balance-sheet activity, and require them to maintain sufficient liquidity as well. Combined with a tough leverage cap, such rules will help ensure that an unexpected shock – whether from the mortgage sector or someplace else – will never again threaten to bring down the broader financial system and inflict so much pain on the American people.

For those who worry that limiting leverage is somehow inconsistent with American tradition, it is worth remembering that the nation's founders strictly limited bank leverage in their own time, frequently at less than 4-to-1. Although bank runs remained a problem in early America because of the absence of deposit insurance, the dangers of high

leverage were already well appreciated. Let's not lose sight of that wisdom now.

Introduction to Legal Reasoning

James Kwak | 22 Feb 2010

By James Kwak

As many of you know, I am a law student. The law is a fascinating subject . . . if you are fascinated by the art of making fine distinctions that most people think are silly. So I thought that the subject of John Yoo and the torture memos might be good material for a good primer on how lawyers think.

The procedural facts are that the Justice Department's Office of Professional Responsibility wrote a report severely criticizing John Yoo and Jay Bybee for various ethical lapses. Associate Deputy Attorney General David Margolis, however, decided not to take further action against Yoo and Bybee.

As Jack Balkin, a professor at my school and noted blogger, explains, the issue was what standard to use in evaluating their behavior. Standards are one of the great joys of the legal profession. As any watcher of *Law and Order* knows, defendants in criminal cases must be found guilty "beyond a reasonable doubt," whatever that means. (Hint: it doesn't mean beyond *any* doubt.) In this case, the Office of Professional Responsibility found that Justice Department lawyers had "a duty to exercise independent legal judgment and to render thorough, objective, and candid legal advice," which seems reasonable. But in Balkin's words, "This standard, Margolis explained, is much too high a requirement and not one that Yoo and Bybee were previously warned was the standard to which they would be held."

Lawyers everywhere, breathe easy: you can't be held accountable if you fail to "render thorough, objective, and candid legal advice."

"Instead, Margolis argues that, judging by (among other things) a review of D.C. bar rules, the standard for attorney misconduct is set pretty damn low. . . . To show misconduct, according to the standard that Margolis finds most relevant, one would have to show that Yoo or Bybee *intentionally made arguments that they knew were wrong and false or did so not caring whether they were wrong or false.*"

(Emphasis added.) Did they?

“As for John Yoo, Margolis explains (although he puts it far more diplomatically) that Yoo was an ideologue who entered government service with a warped vision of the world in which he sincerely believed. . . . Therefore it is hard to conclude that Yoo deliberately gave advice that he knew was wrong to the CIA. Yoo isn’t putting people on when he says the absurd things he says in these memos and elsewhere.* He actually believes that the President is a dictator and that the President doesn’t have to obey statutes that make torture a crime.”

Crazy lawyers everywhere, breathe easy. In short, you can have a completely twisted notion of the law; but as long as you really believe it to be true, you won’t be disbarred.

Is this right? Of course not (in the normative sense, that is). In ordinary civil liability suits, you can be held liable simply for not behaving the way a reasonable person would under the same circumstances. Even the criminal law is full of statutes that punish defendants for outcomes that they didn’t intend. Do we really want lawyers out there who think crazy things are true? We’re not talking about criminal prosecution in this proceeding, just about potentially disbaring Yoo and Bybee — that is, protecting potential future clients from them. And even if you want to protect lawyers in general against being punished for making honest (if crazy) mistakes, wouldn’t you want to hold government lawyers to a higher standard?

Margolis’s standard is extremely high: not only do you have to *know* you are saying stupid things, you have to *not care* that you are saying stupid things. This is the kind of protection that is usually reserved for people charged with really serious offenses. For example, according to the Model Penal Code,** if you create a homicidal risk and someone gets killed, but you weren’t aware of the risk, you are only guilty of negligent homicide. If you are *aware* that you are creating a substantial homicidal risk, that qualifies as reckless homicide, which is still only a form of manslaughter. To be guilty of murder, you have to not only be aware of the risk, you also have to show extreme indifference to the value of human life. In other words, not only do you have to *know* you are putting lives in danger, you have to *not care*.

As Balkin puts it, “In effect, by setting the standard of conduct so low, rules of professional conduct effectively work to protect all those lawyers out there whose moral standing is just a hair’s breadth above your

average mass murderer. This is how the American legal profession simultaneously polices and takes care of its own.”

So it seems like Yoo and Bybee can skate by. Brad DeLong thinks, however, that Yoo is guilty even by Margolis’s standard, because he intentionally made incorrect arguments and didn’t care that they were false.

* For example:

“What about ordering a village of resistants to be massacred? ... Is that a power that the president could legally—”

“Yeah,” Yoo replied, according to a partial transcript included in the report. “Although, let me say this: So, certainly, that would fall within the commander-in-chief’s power over tactical decisions.”

“To order a village of civilians to be [exterminated]?” the OPR investigator asked again.

“Sure,” said Yoo.

** Actually, according to my criminal law professor’s account of the MPC.

Happy CARD Act Day

James Kwak | 22 Feb 2010

By James Kwak

Most provisions of last year's CARD Act restricting certain types of behavior by credit card issuers go into effect today. Card issuers, of course, are adapting by seeking out new ways to make money. One, pointed out by [Felix Salmon](#), is expanding their usage of rewards cards, since (according to [the Times](#)) they get a higher interchange fee on rewards cards than on other cards. (This baffles me, but whatever.) Rewards programs, as it turns out, are subsidized by everyone in the form of higher prices for all goods bought at retail.

Put another way, this is the credit card industry (partially) shifting its sights from consumers, who benefit from (modest) legislative and regulatory protections, to the retailers, who don't. It's also what you would expect when you have extremely high concentration among card issuers (and transaction networks) and low concentration among retailers. Perhaps consumers aren't the only constituency that needs a little protection.

Big Banks Are More Expensive

James Kwak | 23 Feb 2010

By James Kwak

From Stacy Mitchell of the [New Rules Project](#), also on the [Huffington Post](#):

This is something I've long suspected based on anecdotal evidence. According to Mitchell, it's nothing new:

"The Fed's 1999 report, published five months before the Financial Services Modernization Act passed, found that overdraft fees were 41 percent higher at big banks compared to small. Big banks charged more for almost every fee imaginable, including 43 percent more for bounced checks, 57 percent more for stop-payment orders, and 18 percent more for ATM withdrawals.

"But rather than allow the evidence in favor of smaller banks to guide policy, Congress decided to get rid of the evidence. At the urging of then Fed chairman Alan Greenspan, Congress ordered the Federal Reserve to stop publishing its annual report on bank fees. . . .

"But, as it turns out, the firm that the Fed once employed to gather this data, Moebs Services, has continued to survey fees at more than 2,000 financial institutions. Moebs agreed to share its 2009 data with the New Rules Project. As our charts show, the biggest banks still impose much higher costs on their customers than small financial institutions do.

"Not only are fees lower, but several studies have found that smaller banks and credit unions pay higher interest on savings accounts. In a study published by the Federal Reserve Bank of Cleveland, researchers Kwangwoo Park and George Pennacchi examined data from 1998 to 2004 and found that rates on one-year CDs were an average of 14 percent higher at small banks (under \$1 billion in assets) than at large ones (assets of \$10 billion or more) and rates on interest-bearing savings accounts were 49 percent higher."

The article discusses some reasons why consumers continue to pay more in fees and get less interest on deposits. I think it's a combination of

better marketing by big banks, a general lack of comparison shopping, and low fee transparency. (Price competition often begins and ends at the words “free checking.”) Big banks are also somewhat stickier because they can cross-sell more products, which makes them harder to leave. But it can be done.

Prospects For Financial Reform

Simon Johnson | 23 Feb 2010

By Simon Johnson

The best opportunity for immediate reform of our financial sector was missed at the start of the Obama administration. As Larry Summers and Tim Geithner know very well – e.g., from their extensive experience around the world during the 1990s (see [Summers's 2000 Ely lecture](#)) – when a financial system is in deep crisis, you have an opportunity to fix the most egregious problems. Major financial sector players are always good at blocking reform – except when they are on the ropes. (Look again at Paul Blustein's *The Chastening* for more detail on what Geithner-Summers, with David Lipton and others, got right when they sided with reformers in Korea.)

Congratulations to the Treasury PR people for placing such a warm and fuzzy article about Secretary Geithner in *Vogue* (not available online, but definitely worth finding; nice photos). But what exactly was the point – unless Mr. Geithner is planning to run for the Senate in Massachusetts? Mr. Geithner comes through as someone who, against much advice, decided to stick with exactly the financial sector that got us into such deep trouble – despite the fact that this is exactly what he and his colleagues (at Treasury, at the IMF, and at the NY Fed) have always, and with good reason, strongly urged other countries not to do.

Naturally, the Obama administration's generally weak and unfocused financial reform proposals have morphed into generally weak and unfocused congressional bills. The overall narrative has been lost – despite moments of clarity from the president (e.g., when he spoke first about the Volcker Rules, but this was spun away within 12 hours by Secretary Geithner and others on the team).

Some limited change may now emerge from the Dodd-Corker compromise. I expect we'll see a version of the "resolution authority", despite the fact this is a complete unicorn – a mythical beast with magical properties, but not actually useful in the real world.

I've recently asked senior executives from both Goldman Sachs and JP Morgan Chase – both proponents of a resolution authority – point blank to explain how a US resolution authority of this kind would help close down their cross-border firms (or Citigroup). I'm still waiting for an answer.

No doubt there will be some sort of “systemic regulator”, meaning a group chaired most likely by Treasury. This is a great fuss about essentially nothing. On top of the obvious points about how hard it would be for such a body to act preemptively – particularly when our next wave of problems will again be cross-border, in terms of exuberant lending into emerging markets – we actually already have the functional equivalent: the President’s Working Group on Financial Markets.

This group, of course, was to used to great effect by Robert Rubin and others in blocking Brooksley Born in 1998 - to them, she was the systemic threat, because she wanted to regulate over-the-counter derivatives. And the same group was used to no effect whatsoever by Hank Paulson in the run-up to the September 2008 crisis. In the European Union, creating new committees can make a difference; we’re better on form over structure in the US – but when the big banks are so powerful and out of control, we’re lousy at both.

Sadly, the consumer protection agency is likely to be gutted as the price of bringing Senator Corker on board. This is of course an affront to everyone who has been – and continues to be – ripped off by the financial sector. But we are where we are in terms of the blatant mistreatment of customers in this society. Business people often tell me that we need to “rebuild confidence” in this economy. I couldn’t agree more, but how does cheating people – and refusing to prevent others from cheating – lead to more confidence?

Despite – or rather because – of all the arrogance and misbehavior among our more prominent financial players, we are making progress on the bigger agenda: Changing the consensus on what is regarded as safe and sound in all kinds of banking.

Yesterday, Jerry Corrigan of Goldman Sachs told the UK parliament that there was “nothing inappropriate” in the way Goldman helped arrange for Greece to hide its debts. This was helpful – it essentially acknowledges that the much vaunted “reputation effects” of issuing securities with a top tier investment bank are worth less than zero. Mr. Corrigan affirmed that it is completely acceptable for Goldman and its peers to mislead investors and deceive the markets.

So you can strike out one more purported reason why we should keep massive global financial institutions. They do not enhance transparency, they do not bring clarity, they do not keep governments accountable. Instead, they are paid a great deal of cash to mislead people. What is the social value of that exactly?

With the broader financial picture unchanged - major banks will make lots of money, while unemployment remains sickeningly high – legitimate concerns about the practices of Big Finance continue to build. Small and medium-sized banks find themselves increasingly hit by commercial real estate woes. The alliance that has held back reform begins to crack.

Very few people now claim that serious reform is only proposed by people carrying pitchforks; that myth is long gone. The middle of the consensus has started to move, against mega-banks and against dangerous overborrowing by the financial sector. This will be a long hard slog, but we are finally heading in the right direction.

The PR War

James Kwak | 23 Feb 2010

By James Kwak

Every major bank other than Goldman Sachs must be ecstatically happy that Goldman exists, soaking up all the attention with its escapades in Greece and Italy. The other banks, by contrast, are trying to make themselves out to be white knights. See, for example, JPMorgan's ad today in multiple major print newspapers describing its commitment to small business lending:

Like that picture of small-town America?

The main claim is in the second paragraph: a commitment to lend \$10 billion to small businesses in 2010. These kinds of marketing claims are difficult to verify. But I gave it a shot.

"Small business" lending, in JPMorgan's financial supplements (great web page, by the way), is almost certainly "Business banking origination volume," on page 13 (PDF page 14) of the most recent supplement. To see how JPMorgan Chase defines its business lines, see page 3 (PDF page 8) of this Realigned Financial Supplement. "Middle Market Banking" is included in Commercial Banking. So the "Business banking" segment of Retail Financial Services is almost certainly small business lending.

What does \$10 billion mean? First let's look at the history, thanks to those helpful supplements.

That's called falling off a cliff. In words, JPMorgan Chase's small business lending fell by two-thirds from 2007 to 2009. Or, in slow motion:

Note that the economic recovery began in Q3 2009 — no thanks to JPMorgan, apparently.

Still, \$10 billion is still an increase over the previous high of \$6.9 billion in 2007, right? Well, not quite. Because in the meantime, JPMorgan Chase went and bought Washington Mutual. At the end of 2007, Washington Mutual held over \$47 billion in commercial loans of one sort or another (from a custom FDIC SDI report that you can build here). Most of those are not small business by JPMorgan's definition, since commercial real estate and multifamily real estate got put into the Commercial Banking business after the acquisition. But that still leaves \$7.5 billion in potential small business loans, up from \$5.1 billion at the end of 2006, which means WaMu did at least \$2.4 billion of new lending in 2007.

I don't know how much of this is small business lending, but this is part of the problem — banks can choose what they call small business lending, and they can choose to change the definitions from quarter to quarter. It's not also clear (from the outside, at least) what counts as an origination. If I have a line of credit that expires and I want to roll it over, does that count as an origination? My guess is yes. Should it count as helping small businesses and the economy grow? No.

Finally, according *to the ad itself*, JPMorgan Chase has lent \$800 million to small businesses in the first seven weeks of the year. At that rate, they'll get to about \$6 billion for the year. *After* the Washington Mutual acquisition. *After* the closure of close to two hundred smaller banks that were not considered too big to fail. That's not something to run an ad about.

Everyone Was Doing It

James Kwak | 23 Feb 2010

By James Kwak

Gerald Corrigan, a Goldman Sachs executive and a former president of the New York Fed, had a curious defense of the Greece-Goldman interest rate swaps. Here are some direct quotations from the [Bloomberg story](#):

“[The swaps] did produce a rather small, but nevertheless not insignificant reduction, in Greece’s debt-to-GDP ratio,” Gerald Corrigan, chairman of Goldman Sachs’s regulated bank subsidiary, told a panel of U.K. lawmakers today. The swaps were “in conformity with existing rules and procedures.” . . .

“There was nothing inappropriate,” Corrigan told Parliament’s Treasury Committee. “With the benefit of hindsight, it seems to be very clear that the standards of transparency could have, and probably should have been, higher.” . . .

Goldman Sachs was “by no means the only bank involved” in arranging the contracts, Corrigan said. . . .

“Governments on a fairly generalized basis do go to some lengths to try to ‘manage’ their budgetary deficit positions and manage their public debt positions,” Corrigan said. “There is nothing terribly new about this, unfortunately. Certainly, those practices have been around for decades, if not centuries. We have to keep that perspective.”

In other words:

- Governments try to hide their debts.
- Goldman helped make this possible.
- Everything was legal at the time.
- Everyone was doing it.

Corrigan is probably exactly right on all of these points. But this is an admission that banks have been helping governments hide their debts, and a defense on the grounds that everyone was doing it and no regulator complained. (I imagine Goldman must be getting tired of being picked on for simply doing the same things other banks were doing — but making more money than anyone else doing it.) Note, however, that Corrigan doesn’t try to argue that helping governments hide their debts is a good thing.

The underlying problem, I think, is that accounting for derivatives has lagged far behind actual derivatives. I believe that Satyajit Das's book *Traders, Guns and Money* (I don't have my copy with me) has examples of how private companies use interest rate swaps to shift losses from the present into the distant future. If companies are doing this, we should not be surprised that governments are doing it, too. Still, that doesn't make it right.

Banking Industry: Sicker, More Concentrated

James Kwak | 24 Feb 2010

By James Kwak

The rapid bounce-back of some of the big banks (notably Goldman and JPMorgan) has overshadowed (at least on the front pages of major newspapers) the continued plight of the banking sector as a whole. Calculated Risk highlights the FDIC's Quarterly Banking Profile, which lists 702 problem banks with over \$400 billion in assets — the highest year-end figures on both metrics since 1992, as the savings and loan crisis was tailing off.

A few other summary points from the report:

- Profits are small — actually, nonexistent except at larger banks: “The average return on assets (ROA) for all four of the asset size groups featured in the Quarterly Banking Profile was better than a year ago, although only the largest size group—institutions with more than \$10 billion in assets—had a positive average ROA for the quarter.”
- Bank balance sheets continue to get worse, with net charge-offs increasing for the twelfth consecutive quarter.
- Lending continues to fall: “Total loan and lease balances declined for the sixth consecutive quarter in a row.” Total bank balance sheets fell by 5.3 percent — “the largest percentage decline in a year since the inception of the FDIC.”
- Concentration is increasing, with 319 banks vanishing due to mergers or failure in 2009.

See also the Washington Post article, where Sheila Bair blames the large banks: “Bair said that the vast majority of the decline was the result of lending cutbacks by the largest banks, which have tightened qualification standards and increased the proportion of money that they hold in reserve against unexpected losses.”

Undoubtedly many small banks are cutting back on lending because losses are eating into their capital and forcing them to contract. But I think what frustrates Bair is that the larger banks — which are more profitable (in part by charging higher fees) and which enjoyed more government support — are also cutting back.

Volcker Rules?

Simon Johnson | 24 Feb 2010

By Simon Johnson

Bloomberg reports this morning that Treasury is gently letting the Volcker Rule (limiting proprietary trading for big banks) slip - Secretary Geithner would grant greater discretion to regulators which, in today's context, most likely means not make the restriction effective.

This step is consistent with the broader assessment of the Volcker Rules that Peter Boone and I have in *The New Republic* (print and on-line): the underlying principles are sound, but the Rules have not been well-designed, and top people in the administration show little sign of wanting to make them effective. This dimension of financial reform does not appear to be headed anywhere meaningful – and the main issues (bank size, capital, and derivatives) are not yet seriously on the table.

In the recent Senate Banking hearings on the Volcker Rules, John Reed – former head of Citibank – was adamant that the Volcker Rules made sense and could be made to work. His point is that the executives know who is taking risk with the bank's balance sheet – it's a well-defined group within any bank with its own (speculative) culture – and this should be discontinued for banks that are in any sense too big to fail.

You really do not want high octane speculators at the heart of this country's largest banks. Make banking boring, Reed argues with conviction.

The IMF Cannot Help Greece

Simon Johnson | 24 Feb 2010

*This guest post is by Carlo Bastasin, a visiting fellow at the Peterson Institute for International Economics. An economist and a journalist, Carlo is a leading commentator for the Italian daily *Il Sole-24 Ore* and for German newspapers. He reacts here to recent proposals that Greece should bring in the IMF.*

The Greek crisis has at least two different dimensions. One is a fiscal deficit, aggravated by Athens' mismanagement and deception; the other is the protracted loss of competitiveness, especially within the Eurozone, leading to a large current account deficit.

The IMF can be very effective in tackling the problems of solvency and liquidity arising from the fiscal emergency – and it has probably more expertise than the European Union (EU) or the European Central Bank (ECB) in this regard. But the Fund is much less able to address the problem of restoring equilibrium in current account balances within the Eurozone.

Unfortunately these two problems must be solved together. The Greek fiscal deficit and the loss of competitiveness are connected, because a current account deficit (i.e., imports above exports, implying a deficit in net total domestic savings, otherwise known as importing capital) will make it much more difficult for the Greek government to raise taxes to cover its public deficit. The financial equilibrium of the country is exposed to a sudden increase in risk aversion by foreign investors – this is when they would run for the doors, e.g., if taxes increase.

Classic answers to the loss of competitiveness are also problematic. Lowering wages can be useful to restore an efficient cost structure but may also be destabilizing in the short term, because this would reduce tax revenues and thereby affect severely the public fiscal deficit.

Healing the current account problem by reducing Greek domestic demand relative to the demand of the trade partners (mainly countries of the Eurozone) can transform the trade problem (and the debt refinancing problem) into a structural debt sustainability trap – if Greece's growth prospects are more limited, its existing debt burden is more onerous. This can only be avoided if domestic demand in Greece's trade partners increases sufficiently.

In other words, the Greek problem is a mirror image of the "hidden" German problem — too low domestic demand and trade competition based on lowering labor costs in Germany. You cannot imagine really

solving the Greek imbalance without – at least somewhat – correcting the German imbalance.

This is not a problem that the IMF can address. It is not conceivable that in any intervention on Greece, the IMF would turn its “conditionality” to Germany, i.e., asking it to change its trade practices and its social model.

We face a problem of policy coordination within the Eurozone. And this must be resolved collectively – through shared governance mechanisms.

It will need to be an extremely delicate set of policy changes. Correcting the German imbalances cannot be allowed to damage the successful – but socially very painful – recovery in productivity that Berlin was able to stage in the last seven years.

Probably there is no other way than accepting the political task that the Eurogroup will have to face. Policy coordination needs to reach down to the root of the social model – the relation between Capital and Labor, the holy grail of national political consensus – and move it to the level of governments sharing the euro (i.e., the Eurogroup level).

Brad Miller's Challenge

James Kwak | 24 Feb 2010

Since the peak of the financial crisis, both the Bush and Obama administrations have been trying to rescue both large banks and homeowners, often announcing programs for both in the same press conference. The programs for large banks have gone well, from the beneficiaries' perspective (but not for small banks); programs for homeowners, not so much. As more people walk away from underwater mortgages, Assistant Treasury Secretary Herb Allison recently said, "We haven't yet found a way of dealing with this that would, we think, be practical on a large scale."

The failure of the Obama administration so far to come up with a working solution to the problem of mass defaults and foreclosures may be due to practical barriers, such as lack of capacity among mortgage servicers or legal uncertainties regarding securitization trusts. Alternatively, however, it may simply be that the administration doesn't care that much. Perhaps the primary goal of homeowner assistance all along was to detoxify the toxic assets on large banks' balance sheets; now that those banks are off of life support, maybe the mortgages themselves don't matter that much.

Congressman Brad Miller's proposal in *The New Republic* should put that question to the test.*

Miller says we should stop expecting the mortgage lenders, securitizers, and servicers who created this mess to be the ones to clean it up. Instead, the government should create a new Home Owners' Loan Corporation, modeled on the one created by FDR in June 1933 (*three* months after taking office), to buy up mortgages and modify them. The HOLC could pick and choose the mortgages it buys and modifies, so it could focus on mortgages that could be successfully modified to keep the homeowner paying something and give the HOLC a small profit. I spent half the article wondering how the HOLC could avoid overpaying for the mortgages (since the banks would try to hold it up for a high price), and then Miller suggested the solution: eminent domain. (The idea would be to take market data about mortgage prices and force banks or trusts to accept that in exchange for the mortgages, instead of letting them demand the inflated prices they may be keeping those mortgages at on their books.)

Both administrations, and the Federal Reserve, took absolutely extraordinary measures to rescue the financial system, simply shoving the private sector out of the way and, for example, buying over one trillion dollars of agency bonds and mortgage-backed securities in order to prop up prices in the market. By contrast, the homeowner assistance measures have been tentative, based on “nudging” private sector actors to do the right thing through small cash incentives. Those measures have largely failed; the cash incentives seem to be motivating mortgage servicers to “extend and pretend,” stringing homeowners along to keep them paying something without ever making the principal reductions that are necessary for a real solution.

Will the administration take bold measures — either those suggested by Miller, or something else commensurate with the steps taken to save large banks — to keep homeowners in their houses and stop the wave of foreclosures? Or is it content to pretend that its half-measures are working?

* Note that as far as I can tell Miller actually writes his own articles (and blog comments, even), as opposed to many public figures.

Update: Paul Kiel at ProPublica has yet another story on the challenges facing homeowners trying to get their mortgages modified through the government’s program. Among other things, modification trial periods were supposed to last only three months, yet 475,000 homeowners have been in trial periods for longer. That’s a lot of people. This is the problem that Miller is trying to fix. The administration may not agree with his solution, but I think something similarly bold is necessary.

Should We Fear China?

Simon Johnson | 25 Feb 2010

By Simon Johnson. This post is taken from testimony submitted to U.S.-China Economic & Security Review Commission hearing on “US Debt to China: Implications and Repercussions” – Panel I: China’s Lending Activities and the US Debt, Thursday, February 25, 2010. (Caution: this is a long post, around 1500 words; a summary of some key points will appear on the NYT’s Economix this morning.)

China is the largest holder of official foreign currency reserves in the world, currently estimated to be worth around \$2.4 trillion – an increase of nearly \$500 billion in the course of 2009 (on the back of a current account surplus of just under \$300 billion, i.e., 5.8 percent of China’s GDP, and a capital account surplus of around \$100 billion). These reserves are accumulated through arguably the largest ever sustained intervention in a foreign exchange market – i.e., through The People’s Bank of China buying dollars and selling renminbi, and thus keeping the renminbi-dollar exchange rate more depreciated than it would be otherwise.

China is also currently the second largest holder of US Treasury Securities – at the end of December 2009, it held \$755.4 billion – just behind Japan (which had \$768.8 billion).

The US Treasury data almost certainly understate Chinese holdings of our government debt because they do not reveal the ultimate country of ownership when instruments are held through an intermediary in another jurisdiction.

For example, UK holdings of US debt rose during 2009 from \$130.9 billion to over \$300 billion, despite the fact that the UK ran a substantial current account deficit last year. A great deal of this increase may be due to China placing off-shore dollars in London-based banks (Chinese, UK, or even US), which then buy US securities. China may also purchase US securities through other routes.

China is presumed by most observers to hold the majority of its incremental reserve accumulation in US Treasuries – this makes sense given that the other potential reserve currencies (euro, yen, and pound) all have serious issues – but according to the official US data, Chinese holdings peaked at \$801.5 billion in May 2009 and fell by about \$50 billion during the remainder of the year. A modest fall in true Chinese Treasury holdings – given slower reserve accumulation in December and

the likely desire to diversify – is not completely implausible. But there are no indications that China is moving out of Treasuries in any large scale manner.

While the exact amount is not knowable based on publicly available information, a reasonable working assumption would be that China owns close to \$1 trillion of US Treasury securities, i.e., perhaps half of the stock of treasuries in the hands of “foreign official” owners, which was \$2.374 trillion (at the end of 2009, with the important caveat that other governments may also hold Treasuries through circuitous routes) and just under 1/7 of all US government securities outstanding (\$7.27 trillion, of which \$3.614 trillion was held by all foreign owners, official and private, at the end of 2009).

There is a perception that China’s large dollar holdings confer upon that country some economic or political power vis-à-vis the United States and, in particular, that Chinese reserves prevent us from putting pressure on that country’s authorities to revalue (i.e., appreciate) the renminbi. This view is incorrect and completely misunderstands the situation.

It is in the interests of both the United States and global economic prosperity that China discontinues its massive intervention in the market for renminbi. This intervention is a breach of China’s international commitments (as a member of the International Monetary Fund) and constitutes a form of unfair trade practice.

If China were to end its intervention, the renminbi would appreciate substantially – likely in the region of 20-40 percent. China would also stop accumulating dollars (and other foreign assets).

The primary effect would therefore be an effective depreciation of the US dollar against the Chinese renminbi – and against all other countries’ currencies that are implicitly pegged to the renminbi (more precisely, to the dollar rate with an eye on China’s competitiveness). On a trade-weighted basis – and in real effective terms (despite the fact that the currencies of our other major trading partners float freely) – the dollar would also likely fall in value.

Such a movement in the dollar would help expand our exports and improve our ability to compete against imports; this would aid in the process of recovery, job creation, and broader adjustment in the US economy. Even a substantial movement in the dollar – e.g., a 20 percent depreciation in real effective terms, which is most unlikely – would have no noticeable effect on inflation and therefore would not force the

Federal Reserve to increase interest rates. The “hard landing” scenario for the dollar – feared by analysts since the traumatic experiences of the 1970s – is unlikely for the US today, given the low level of inflation expectations and the high “output gap” (reflected in measured unemployment near 10 percent and true unemployment of at least 15 percent).

The effect on short-term US interest rates would therefore likely be minimal or nonexistent, particularly as the Federal Reserve currently aims to keep rates close to zero. The effect on longer-term US interest rates would also be small – and could be offset by the Federal Reserve, as it currently seeks to limit all benchmark interest rates (most recently affirmed by Chairman Bernanke this week).

In fact, the current stance of monetary policy – and the low, stable level of inflation expectations in the United States – makes this an ideal moment at which to press China to revalue its currency.

In another potential scenario, there is concern that China would threaten to reduce its purchases of US government securities without allowing its currency to appreciate. But if China continues to intervene to maintain its currency peg, it will accumulate foreign reserves – so they need to hold increasing amounts of foreign assets of some kind. What else would the Chinese authorities buy?

1. If they buy other dollar denominated assets issued by US entities, this would push down spreads on those assets relative to Treasuries. This would directly help private US borrowers – thus stimulating growth in the US.
2. If they directly buy dollar denominated assets issued by non-US entities, this will still reduce spreads more broadly and help US borrowers – as there is a global market for dollar assets and there is not much high grade non-US dollar debt available for sale.
3. If they buy dollar equities – which is most unlikely – this would help the stock market, household balance sheets, and firms’ access to funding (as well as helping to shift our economy from debt to more equity financing, which would a desirable move in any case.)
4. If they buy non-dollar assets, given that the Fed will keep interest rates near to zero, this will push down the value of the US dollar and help boost US growth. Such a move would produce protests from the eurozone and Japan, but this change in currency value would be solely China’s responsibility.

If China stops buy foreign assets altogether, this would of course be equivalent to ending foreign exchange intervention. This is exactly the policy change that we should be seeking.

In addition, there are significant potential losses – in terms of net foreign assets – for China if their authorities sell Treasuries or otherwise undermine the value of the dollar (or intentionally roil markets) with negative comments. A depreciation of the dollar directly reduces the value of their foreign holdings and does not, under current circumstances, pose any kind of threat to the US.

There is still an open question of how best to push China to revalue the renminbi.

1. Bilateral negotiations, as championed for example by former Treasury Secretary Paulson, have achieved essentially nothing since 2002. This is not a promising way forward.
2. The International Monetary Fund (IMF) has proved itself incapable of calling China to account. The IMF's much vaunted "Surveillance Decision" is a failure and the general Fund mandate of "multilateral surveillance" has (again) proved to be a paper tiger. Working with the IMF on this issue is not worth any additional effort by the US government.
3. China is obviously a currency manipulator and should be so labeled by the US Treasury in its next report to Congress. China's threat to react by selling Treasuries is – as explained above – at worst a bluff and at best a way to help the US with a depreciation of the dollar. This bluff should be called.

This, of course, raises the issue of what the US should do beyond applying labels. Bilateral trade sanctions are never a good idea and can easily get out of hand. Given the failure of the existing multilateral mechanisms around the IMF, the US should take up this issue at the level of the G20 – there are two summits of leaders this year and plenty of support around the world for addressing China's exchange rate.

The most plausible proposal is to expand the mandate of the World Trade Organization – which should operate in this respect without the involvement of the IMF – in assessing exchange manipulation on the same basis as it deals with unfair trade practices (as proposed by Mattoo and Subramanian). While full implementation for such a rearrangement of responsibilities would take some years, concrete moves in this direction would concentrate the minds of the Chinese authorities in a potentially constructive manner.

*The remainder of this testimony deals with our broader economic baseline.
Exchanges with Joe Gagnon were most helpful in preparing all this material.*

The Art of Selling

James Kwak | 25 Feb 2010

By James Kwak

This morning I was listening to an especially brilliant This American Life episode from 1999, titled “Sales.” I spent a lot of the past decade selling — first pitching my startup company to venture capitalists (not very well), then pitching software to potential customers (a bit better). The first segment — Sandra Tsing Loh listening in as a screenwriter pitches his story to two movie producers — absolutely nails the the staging of a sales call, including the forced casualness of pretending that huge amounts of money aren’t at stake, the small talk (is it good for there to be a lot of small talk?) and the water bottles, the seller talking uncomfortably fast when he doesn’t get feedback cues from the buyers, and the uncomfortable close and the confused debrief. (However, Loh and the screenwriter broke one of the cardinal rules we used to follow: don’t say a word about the meeting until you are safely out of the building, not even — especially not — in the bathroom.)

The third segment — in which a reporter reflects on his time as a radio advertising salesman — also perfectly illuminates the interpersonal dynamics and moral ambiguities of being a successful salesperson. Is it right to sell someone a product he doesn’t need and that isn’t actually good for him? Of course it’s legal, but is it right? If he buys it, is it his fault . . . or yours? What do you do when your skill at getting people to like you* causes your potential clients to open up to you in ways that are not in their interests?

Once someone came to our office to give me a sales pitch. By the end of the pitch, I had the feeling that we were good friends. Later, thinking about that, I felt used. How could this person manipulate me into thinking we were friends in just forty-five minutes? Then I realized this was the best salesperson I had ever seen. And we are friends now. (Or at least I think so.)

In between, the second segment is screamingly funny.

* A skill I don’t really have, by the way.

Update: I should say that I don’t actually have the negative opinion of sales and salespeople that some of the comments below seem to assume I have. As I said, I’ve spent a lot of my time selling, and I don’t think I’m a bad person. For one thing, sales is as critical to the economy as design and production. The rituals of sales — particularly high-touch selling of

very expensive products, which is what I was involved in — were established before any of us got into the business, and all salespeople have to conform to them, more or less. Many if not most salespeople really believe that most of their customers will be better off if they buy their products. On the other hand, this is one way that salespeople justify pushing at the envelope of truth on occasion — it's for the customer's good, after all. (The other big reason for this behavior is that the market for certain products has settled into an equilibrium where all the competitors are exaggerating, and the customer assumes that you are exaggerating, too, and discounting everything you say, so if you don't play the game you have no chance.)

Should China Fear Us?

Simon Johnson | 26 Feb 2010

By Simon Johnson

Writing partly in response to "Should We Fear China?", Robert Salomon of NYU makes some good points – about how rapid appreciation of the renminbi could hurt China and argues:

Although I agree that it is in the best long-term interest of the U.S. and other countries throughout the globe for China to revalue its currency, it isn't entirely clear to me that such a maneuver is in the near-term interests of China, ...or maybe even the global economy.

Robert's concerns are focused on the effects of a sudden revaluation – a movement in the exchange rate that would be disruptive to Chinese production and plunge that country into recession. But that scenario hardly seems likely.

Even if the US decides to press China hard on the exchange rate issue, we currently lack instruments to make this pressure effective. Working through the IMF is not appealing – because it just won't work – and the World Trade Organization (WTO) does not have sufficient jurisdiction on exchange rate issues (if pushed today, it would bring in the IMF to determine the extent of exchange rate undervaluation; again, we're back to the IMF impasse).

To be sure, Congress could threaten bilateral action but this is a blunt weapon that can easily cause a great deal of collateral damage. At the Commission's hearings on Capitol Hill yesterday, the consensus appeared to be that China should be pressed harder on its exchange rate – including being labelled a "currency manipulator" by Treasury at the next opportunity (in April) – but we should not rush towards any kind of trade war.

It would be much better to give the WTO teeth vis-a-vis exchange rate manipulation, but this will take a while. Even in the best case scenario, effective pressure will build only slowly on China.

On the other hand, if China steadfastly refuses to appreciate the renminbi in any significant manner, the damage when the exchange does eventually move could be even greater.

We should not fear China – our problems are about ourselves, not anyone else. China should likewise mostly fear the unintended consequences of their own misguided policies.

What Will We Know And When Will We Know It?

Simon Johnson | 26 Feb 2010

By Simon Johnson

One of the most basic questions in economics is: Which countries are rich and which are relatively poor? Or, if you prefer a highly relevant question for today's global situation, who recovers faster and sustains higher growth?

The simplest answer, of course, would be just to compare incomes – i.e., which country's residents earn the most money, on average, at a point in time and how does that change over time?

But prices differ dramatically across countries, so \$1,000 in the United States will generally buy fewer goods and services than would the same \$1,000 in Guinea-Bissau (although this immediately raises issues regarding consumer's preferences, the availability of goods, and the quality of goods in very different places.)

The standard approach developed by economists and statisticians, working with great care and attention to detail on a project over the past 40 years known as the "Penn World Tables", is to calculate a set of "international prices" for goods – and then to use these to calculate measures of output and income in "purchasing power parity terms." For countries with lower market prices for goods and services, this will increase their measured income relative to countries with higher market prices (with Gross Domestic Product, GDP, per capita being the standard precise definition, but components and variations are also calculated along the way).

Some of the limitations inherent in the Penn Tables are well known. But it turns out there are other, quite serious issues, that should have a big effect on how we handle these data – and how doubtful we are when anyone claims that a particular country has grown fast or slow relative to other countries.

The Penn Tables are based on collecting detailed price information – what it actually costs to buy all kinds of things in different places. But the basic problem is that the people running the Tables do not have access to such data for all years and all countries – so they have to make a number of moderately heroic assumptions.

In "Is Newer Better?", we show that a particular technical issue – the extrapolation of estimated price levels backwards and forwards in time –

has a big impact on estimated GDP. This in turn changes, dramatically in some cases, the calculated growth rates for particular countries; and these changes can be huge for smaller countries with less good data, particularly when the year in question is quite far from the moment when prices were actually “benchmarked” though direct observation.

Just to illustrate our point, in Table 1 we show that the ranking of growth rates – e.g., top 10 and worst 10 countries, in terms of growth performance – within Africa, from 1975 to 1999, is completely different if you use Penn World Tables version 6.1 or if you use version 6.2. Just speaking for ourselves, we were quite shocked by these differences – and consequently spent a long time digging through the details (see the appendices of the paper for much more than you wanted to know about how this kind of sausage is made). We’ve also tried to figure out exactly how much these issues matter both for how people have studied growth in the past (to do this, we replicated and checked the robustness of 13 influential and indicative papers), and for how to think about (and measure) economic success and failure moving forward.

Our bottom line is: while the Penn Tables are reasonably reliable for comparing changes in income level over long periods of time (e.g., 30-40 years), they are much less appealing – and results based on them will generally not be robust – as a source for annual data. You should regard claims based on such annual data with a great deal of skepticism.

We also suggest there is a different and – for some purposes – better way to use the information in the Tables (see Section 6 of our paper). In essence, we suggest combining estimated GDP levels directly from the Tables, rather than using the standard (and problematic) extrapolation method.

Looking at annual growth rates from national statistics is fine – or at least raises different issues – for thinking about short-term growth dynamics (i.e., who is in crisis, who is recovering, who may be overheating). But for considering longer-run comparisons, say over 5-10 years or longer, you unfortunately cannot avoid worrying about comparable prices and some sort of purchasing power adjustment.

Whether or not you like our specific proposal, the main takeaway point is the same: do not rely on just one growth series. Check that your claims (or anyone else’s) hold across different versions of the Penn World Tables, and – if you are focused on annual growth rates – look also at estimates from the World Bank’s World Development Indicators.

If you are interested in these issues more broadly, see the papers presented at the "Measuring and Analyzing Economic Development" conference at the University of Chicago today.

Financial Innovation, Again

James Kwak | 27 Feb 2010

By James Kwak

I've had Robert Litan's recent paper defending most financial innovation (the web page doesn't tell you much; you need to grab the PDF) on my to-do list for a while now. I wasn't looking forward to writing about it, since I'm a bit tired of the subject, and I don't think I have much more to say. So thankfully Mike Konczal beat me to it, in a two-part series. Part I is really brilliant, and has not one but two insights. The first (to simplify) is that we generally think of innovation in products as making them simply better on all dimensions. We don't realize that, with most new financial products, we are just getting to a new point on the risk-reward spectrum that wasn't there before. Now, it might be good for the economy as a whole for that new point to exist. But as consumers, we don't realize that the good properties of a new financial product are almost invariably counterbalanced by some bad properties.

The second insight is that real, good financial innovation does not look like a new product; it looks like a new way of dealing with an existing product. Konczal's example is TRACE, a recent system for increasing transparency in the market for corporate bonds (you'll have to read his post for a more complete description). The effect has largely been to make pricing more transparent and reduce spreads, which is good for investors. More broadly, as Felix Salmon said somewhere (probably many times), financial innovation should show up as lower prices for all the bread-and-butter financial products—equity and debt underwriting, interest rate swaps, etc.—not as higher profit margins for dealers.

Konczal's Part II asks some more general questions about Litan's results. I have some different questions.

Litan grades each innovation on three dimensions:

"The table illustrates that financial innovations are appropriately measured or 'scored' on three dimensions, of which the net impact on productivity or total output is only one. Financial innovations also have distributional impacts – for example, by expanding access to certain products (loans and investments) – and can affect convenience of the users of financial products and services."

Litan calls these access, convenience, and productivity/GDP. And here are his scores:

But I don't really understand these categories, especially the first two. Take "access." On its face, it seems hard to imagine how a new financial product could reduce "access," whatever that word means here. So you would expect the kind of grade inflation you see in Litan's chart. Sure, I see how ATMs make it easier to access your money. I see how index funds make it easier for retail investors to "access" smart investment strategies. But what about CDOs? Litan says that they made it easier for people to access mortgages:

"While it worked, the CDO thus was instrumental in expanding access to mortgage financing to a large class of people who previously could not buy a home. We know now, of course, that many of these subprime borrowers never should have been offered these loans, especially with little or no down payment and with little or no documentation of their incomes (or lack thereof). But some portion of those who received subprime or Alt-A mortgage financing – we won't know the exact share until the foreclosure crisis has run its course – clearly benefited from it. Thus, on my access and convenience measure, I am inclined to give the CDO a qualified, temporary ++."

I agree with Litan that CDOs increased access in this sense. But *I don't think it was a good thing* to give people access to mortgages they couldn't afford. Litan tries to capture this criticism by giving CDOs a — for productivity/GDP. But I don't think that captures it. I think this increase in access was bad. So if the Access column is supposed to carry a normative judgment, then it should be negative here. Alternatively, I am willing to accept the ++ in the Access column (to mean that CDOs increased access) only if we agree that access itself is neither good nor bad; sometimes it's good, sometimes it's bad. But then all those plus signs under Access should no longer be read as benefits of financial innovation, but simply as descriptions (and near-tautological descriptions at that) of one effect of financial innovation.

Something similar goes for "convenience." What financial innovation would reduce convenience? That's why you see lots of plus signs. But is convenience unequivocally good? The convenience provided by credit cards, home equity loans, and (indirectly) asset-backed securities and CDOs sure made it easier to overborrow and lose your house. Is

convenience always good? I think it's generally good, but there's a second edge to that sword that isn't captured simply in the productivity column.

The weirdness of this chart is underlined by SIVs. Here's Litan:

"Clearly, given this history, it is impossible to score the SIVs' contribution to GDP as anything but -. Indeed, by helping banks to circumvent their capital adequacy requirements, SIVs enabled the banks to excessively leverage what capital they did have, which greatly magnified the economic impact of subprime mortgage losses after housing prices quit climbing and began to fall.

"On a positive note, by adding liquidity to the mortgage securities market, the SIVs temporarily enhanced access to mortgages by subprime borrowers and made it more convenient for them to do so. But even a temporary ++ score on these dimensions cannot come close to making up for the financial damage they helped cause."

So Litan thinks SIVs were bad. I agree. But a casual reader looking across the SIV row will see four plus signs and only two negative signs. Maybe that's the casual reader's fault; but I think it's partly Litan's fault for creating a misleading chart.

That said, I think most of the details in the paper are good. (Although I don't agree that venture capital is a financial innovation—for exactly the reasons Litan puts in his paper.) My main concern on that level is that Litan doesn't always place much weight on the negative side effects. For example:

"As for their contribution to GDP, interest rate and currency swaps reduce the transactions costs of having to sell and buy the underlying loans or bonds. In addition, foreign currency swaps, in particular, facilitate cross-border financial flows, and thus, like futures and options, accelerate globalization and the benefits it brings. My judgment, therefore, is that these arrangements should be scored somewhere between a + and ++ for their contribution to GDP."

As we now know, currency swaps also help governments hide their debt. And we've known for a long time that companies use both interest

rate and currency swaps to massage their earnings. That's a bad thing. Admittedly, it's hard to quantify. But it should be in there somewhere.

“Every Moment Counts”

James Kwak | 28 Feb 2010

By James Kwak

No, it's not a line from a pop song. It's part of my hopeless, Luddite anti-smart phone campaign. This is from an interview with Tachi Yamada, president of the Bill & Melinda Gates Foundation's Global Health Program.

“When you actually are with somebody, you've got to make that person feel like nobody else in the world matters. I think that's critical.” So, for example, I don't have a mobile phone turned on because I'm talking to you. I don't want the outside world to impinge on the conversation we're having. I don't carry a BlackBerry. I do my e-mails regularly, but I do it when I have the time on a computer. I don't want to be sitting here thinking that I've got an e-mail message coming here and I'd better look at that while I'm talking to you. Every moment counts, and that moment is lost if you're not in that moment 100 percent.”

Yamada is just one person; because he feels this way doesn't prove that you should, too. But I bet some of you will agree with him, and will start switching your BlackBerrys off when you are talking to other people. But over time, you will find yourself leaving it on, and then you will find yourself surreptitiously checking it under the table. It's like chocolate ice cream; it's too hard to say no to.



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