

*By Simon Johnson*

On Friday, Senator Bob Corker (R, TN) took to the Senate floor to rebut critics of big banks. His language was not entirely senatorial: “I hope we’ll all come to our senses”, while listing the reasons we need big banks. And Senator Chris Dodd (D, CT) rose to agree that (in Corker’s words) reducing the size of our largest banks would be “cutting our nose off to spite our face” and that by taking on Wall Street, “we may be taking on the heartland.”

Unfortunately, all of their arguments in favor of our largest banks remaining at or near (or above) their current scale are completely at odds with the facts (e.g., as documented in our book, [13 Bankers](#)).

The senators led with the idea that our nonfinancial sector needs huge, complex, global banks in order to remain competitive internationally. But this is completely untrue – in fact, Senator Dodd conceded as much to Ezra Klein recently when he said that he had heard the arguments of [13 Bankers](#) against big banks also from “CEOs” (presumably of nonfinancial companies).

Even the biggest nonfinancial companies do not, under any circumstances, want to buy all their financial services from one megabank. They like to spread the business around, to use different banks that are good at different things in different places – in part to prevent any one bank from having a hold over them. Playing your suppliers off against each other to some degree is always a good idea.

Senator Corker also argued that entrepreneurs need today’s megabanks. Please find me a single entrepreneur who would agree with that statement – keeping in mind that I work with a lot of entrepreneurs in my day job (professor of entrepreneurship, among other things, at MIT, with a particular focus on entrepreneurs working globally). Of course entrepreneurs need access to capital and they need investors who are willing to back risk-takers in the nonfinancial sector, but if you can find a link between that productive activity and what Goldman Sachs is accused of doing by the SEC, write it up.

Senator Corker also stressed that businesses need to be able to hedge risks, e.g., regarding their input prices. This is a fair point but it is completely unrelated to how large our biggest banks should be. This is instead an argument for allowing the existence of derivatives market – like Gary Gensler of the CFTC, we take the view that requiring all derivatives to be traded on exchanges would not only reduce system risk, it would also be completely consistent with all legitimate and productive derivative-related transactions, and it would reduce the size of the largest broker-dealers (who currently have a great deal of market power when so much of derivatives trading is over-the-counter).

Both Senator Corker and Senator Dodd stressed that the biggest US banks are not the biggest banks in the world. But what does that have to do with anything? The largest European banks are again in seriously trouble this weekend – because they piled on exposure to the eurozone periphery in an irresponsible and frankly dumb manner. The largest Chinese banks are a complete mess in terms of governance and ability to make a sensible loan. And [the biggest Canadian banks are underwritten by government guarantees](#) of a nature and scale that make Fannie Mae and Freddie Mac look respectable during the go-go years (which they were not) – we have taken these points up at the highest levels within the Bank of Canada and they get this. So why would anyone think that any of these global banks is an appealing model for the United States to follow?

Senator Corker is opposed to any “arbitrary limit” on bank size. Senator Dodd’s support for Senator Corker on Friday is striking and surprising because, at least nominally, [the Dodd financial reform bill as it came out of committee does cap bank size](#) – see Section 620, “Concentration Limits on Large Financial Firms”:

“Subject to recommendations from the Financial Stability Oversight Council, a financial company may not merge or consolidate with, acquire all or substantially all of the assets of, or otherwise acquire control of, another company, **if the total consolidated liabilities of the acquiring financial company upon consummation of the transaction would exceed 10 percent of the aggregate consolidated liabilities of all financial companies at the end of the calendar year preceding the transaction.** The Council recommendations will be included in a study of the extent to which the concentration limit under section 620 would affect financial stability, moral hazard in the financial system, the efficiency and competitiveness of United States financial firms and financial markets, and the cost and availability of credit and other financial services to households and businesses in the United States. The intent is to have the Council determine how to effectively implement the concentration limit, and not whether to do so. The Council will have six months to write the study, and the Board of Governors of the Federal Reserve will have nine months in which to issue regulations that reflect the recommendations and modifications of the Council.

This is obviously very weak, in part because at best it only applies to acquisitions. This is a significant watering down

of the Second Volcker Rule, [which read in January](#):

“2. Limit the Size- The President also announced a new proposal to limit the consolidation of our financial sector. The President’s proposal will place broader limits on the excessive growth of the market share of liabilities at the largest financial firms, to supplement existing caps on the market share of deposits.”

Unfortunately, for whatever reason, the White House appears to have completely folded on the substance. Larry Summers now [claims \(inaccurately\) “most observers”](#) think breaking up big banks would be a bad idea because,

“Most observers who study this believe that to try to break banks up into a lot of little pieces would hurt our ability to serve large companies, and hurt the competitiveness of the United States.”

“But that’s not the important issue, they believe that it would actually make us less stable. Because the individual banks would be less diversified, and therefore at greater risk of failing because they wouldn’t have profits in one area to turn to when a different area got in trouble.

“And most observers believe that dealing with the simultaneous failure of many small institutions would actually generate more need for bailouts and reliance on taxpayers than the current economic environment.”

The [Brown-Kaufman SAFE banking act](#) would cap banks, as a practical matter, between about \$100 billion and \$450 billion in total assets – depending on their exact risk profile. What exactly is the diversification that you can do at \$2 trillion that cannot be done at \$100 billion?

The Corker-Dodd-Summers view follows closely the line from Hal Scott, a [Harvard law school professor](#) (and a [director of Lazard](#)) who strongly favors the big banks – for example, [he testified against any form of the Volcker Rules](#) when we both appeared before the Senate Banking Committee in February. Scott runs the [Committee on Capital Markets Regulation](#), which recently stated,

“As with the Volcker Rules, the Committee does not believe that size limitations will reduce systemic risk. An institution does not pose systemic risk because of its absolute size, but rather because of its debt, its derivatives positions, and the scope and complexity of its other financial relationships. Because the problem is not size but interconnectedness, reform should focus on reducing the interconnections so that firms can fail safely. Furthermore, even if size were the right issue, the Senate Banking bill would not require any existing bank to shrink; it would only prevent further growth by consolidation or acquisition. Assuming size is the source of systemic risk, we should presumably be concerned about it whether it is the result of acquisition or organic growth.”

Of course the issue is about system risk. Risk is about many things, including the ability of banks (at any size) to circumvent regulation. But risk is also partly a function of bank size – smaller banks are not too big to fail and this affects the incentives of management and directors (as well as traders, depending on the compensation system).

And if you don’t think our largest banks have completely captured the hearts and minds of their regulators – both prior to September 2008 and perhaps even more subsequently – read [13 Bankers](#) and tell us where we got that part of the story wrong.

If you still really don’t want to cap bank size, take a long hard look at the UK, where RBS had a balance sheet of roughly 1.5 times the UK economy when it failed. When it failed in fall 2008, Citigroup had total liabilities around \$2.5 trillion. Would our problems now be better or worse if Citi had had \$5 trillion in assets – or if it had been the size of RBS relative to the UK economy, i.e., roughly \$20 trillion?

As for why exactly Senators Corker and Dodd really support big banks, it seems increasingly likely that this is all about [campaign contributions](#).

## “Most Observers” Do Not Agree With Larry Summers On Banking

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The Baseline Scenario » 2010 » May 5/3/10 at 9:42 AM Simon Johnson

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*By Simon Johnson*

What is the basis for major policy decisions in the United States? Is it years of careful study, using the concentration of knowledge and expertise for which this country is known and respected around the world? Or is it some unfounded assertions, backed by no data at all?

At least in terms of the White House policy towards megabanks, it is currently “no discussion of data or facts, please”.

Speaking on the Lehrer NewsHour last week, Larry Summers said, with regard to the [Brown-Kaufman SAFE banking act](#) – which would restrict the size of our largest banks (putting them back to where they were a decade or so ago):

“Most observers who study this believe that to try to break banks up into a lot of little pieces would hurt our ability to serve large companies, and hurt the competitiveness of the United States.”

“But that’s not the important issue, they believe that it would actually make us less stable. Because the individual banks would be less diversified, and therefore at greater risk of failing because they wouldn’t have profits in one area to turn to when a different area got in trouble.

“And most observers believe that dealing with the simultaneous failure of many small institutions would actually generate more need for bailouts and reliance on taxpayers than the current economic environment.”

I’ve looked into these claims carefully and really cannot find any hard evidence supporting Summers’s position – and therefore US policy. To be sure, there have been assertions made along these lines by a few people.

But can the White House point to any published material or even publicly available analysis or data that is relevant to the questions at hand? How about work that has been presented to critical audiences, preferably with the entire discussion on the public record. I would be happy to be corrected on this – call me – but I can find nothing.

This is not about jumping through any kind of academic hoops – it is simply a question of whether this critical aspect of our public life is post-Enlightenment (i.e., we worry about the evidence) or stuck at the level of unfounded medieval assertion.

On the other side of the argument, I would submit the evidence reviewed in our book [13 Bankers: The Wall Street Takeover and The Next Financial Meltdown](#), which – among other things – surveys the available literature, from both academics and practitioners. Read it for yourself – we wrote it for this moment and this issue. (Or ignore the book if you prefer; this would put you [in good company at the top rungs of our society](#).)

“Most observers” agree with *13 Bankers* on the need to reign in (and constrain the size of) our largest banks. We’ve presented this book and its findings to top lawyers, finance people, both more academic and completely practitioner. We’ve talked about it at length on Capitol Hill and with very experienced people who work or have worked throughout the financial system. We have also argued in detail with anyone who is close to the big banks – although, unfortunately, top executives and their representatives will not come out to debate in the open. The experts are overwhelmingly on board – except for those who work for the big banks.

I would not have a problem with the administration’s top officials saying, “we can’t take on the biggest banks because (a) they are too powerful in general, and (b) they would cut us off from the campaign contributions that we need for November.” This would at least be honest – and then we could discuss whether it makes sense as political tactics.

And if the most senior and experienced economic policymakers in the land wish to make their own assertions, unencumbered by the facts, then you can take a view regarding whether or not they have earned the right to be taken seriously. (By the way, “most observers” think we are very fair to Larry Summers in *13 Bankers*; a significant minority think we are overly generous.)

But for the White House to make inaccurate claims regarding the views of “most observers” is the most obvious and cheapest sham.

Come out and have the discussion on its merits in public. Or just cut off debate in the Senate, through some sleazy backroom deal, and face the consequences.

## Who’s Got Those Pitchforks?

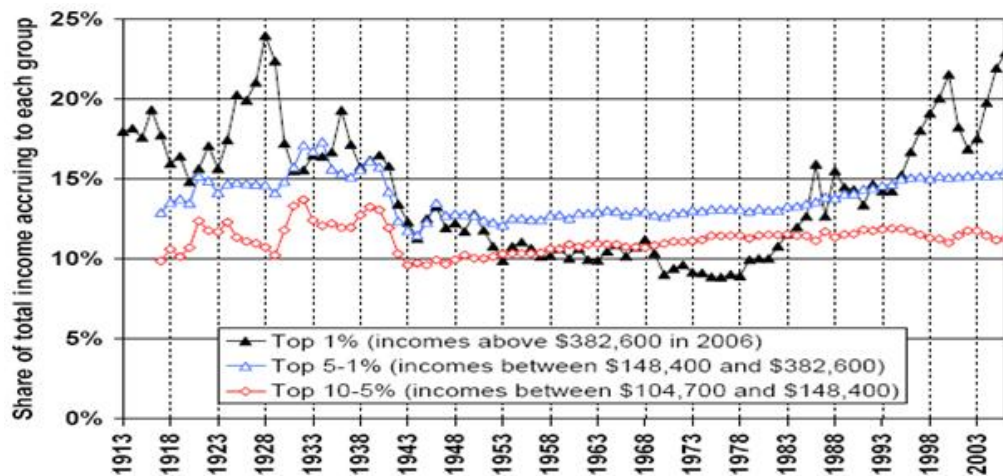
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The Baseline Scenario » 2010 » May 5/3/10 at 5:27 PM James Kwak

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By James Kwak

The Huffington Post Books section is hosting a discussion of *13 Bankers*; there are links to all the posts so far [here](#). Mike Konczal, usually of [Rortybomb](#), [weighed in](#) with a post that included this chart:



People from the 90th to the 95th percentile make about 11% of total income; people from the 95th to the 99th percentile make about 15%; and people in the top percentile make about 23% (in 2006, presumably). But mainly, look at the way that black line shoots up relative to the others since 1980 (along with [financial sector profits and per-employee banking compensation](#)).

One of Konczal's points is that one group that is opposed to Wall Street — and supports stronger reform — is people who are doing well, but not nearly as well as the bankers and fund managers in the top 1%. He focuses in particular on certified financial analysts — people who make a lot of money and know how the financial system operates, and are outraged at Wall Street. 68% of them support the Volcker Rule to prevent banks from engaging in proprietary trading. Konczal calls it the “rage of the 1.5% class.”

Michael Lewis, in an [interview with Christopher Lydon](#), said that in his book tour, a lot of his audiences are well-off and moderate well-off professionals — doctors, dentists, lawyers, small business owners, etc. These are people who (at least according to them) followed the rules, worked hard, paid their taxes, made a fair amount of money, etc. — and just saw the economy almost collapse because of what they see as the shenanigans of a tiny, tiny elite that plays by a different set of rules. Lewis or Lydon (I can't recall which) called it a “revolt of the petty bourgeoisie.” And it is true that one of the societal forces behind the French Revolution was a traditional official class that saw its status threatened by the new capitalist class. (Yes, this is the opposite of what Marx and Engels thought.)

I don't want to make too much of this. But I think it is true that the pitchfork-wielders of today are not rock-throwing Trotskyites; they are, largely, politically moderate (or conservative) people who believe in capitalism and in making money. And I also think that there has been a relative shift in economic fortunes away from the small business owning class that we like to think of as the bedrock of American society (the modern version of the yeoman farmer of the eighteenth century), and toward a new elite made up of corporate CEOs, investment bankers, and hedge fund managers. Where this will end up I do not know.

## Fake Debate: The Senate Will Not Vote On Big Banks

The Baseline Scenario » 2010 » May 5/4/10 at 5:54 AM Simon Johnson

By Simon Johnson, co-author of [13 Bankers: The Wall Street Takeover and The Next Financial Meltdown](#). This post also appears on [pbs.org/needtoknow](#) — as part of that new TV program's coverage of the week's issues.

There is widespread agreement that the financial crisis which broke out in September 2008 was our most severe in over 50 years. There is also a consensus that, whatever other factors may have been involved, the excessive risk-taking and general mismanagement of huge banks at the center of our economy played a significant role in what happened. (Yes, of course the largest banks themselves deny any responsibility — [including most recently using insulting language](#).)

The financial reform package now on the Senate floor [puts surprisingly little constraint on the activities of our largest banks going forward](#) — preferring instead to defer to regulators to tweak the rules down the road (despite the fact that this approach has gone badly over the past 20-30 years).

A growing number of senators insist we should do more to reduce the size and limit the leverage of megabanks (i.e., the amount that banks can borrow), arguing that this would constitute an important additional failsafe – on top of all other efforts to establish “more effective regulation”.

Senator Ted Kaufman (D, DE) has led the charge on this issue, pounding away for months – and giving [another powerful speech on the floor of the Senate](#) yesterday.

Yet, astonishingly, it seems increasingly likely there will be no real Senate debate on this issue.

A real debate, in the modern American system, needs a vote on something specific – in this case, an amendment to the main legislation. And Senator Kaufman, with Senator Sherrod Brown (D, OH), to that end has proposed the [SAFE Banking Act – with meaningful size and leverage caps](#) – which is ideally suited as a way for senators to show whether or not they support the continued existence of our largest banks in their current (very dangerous) form.

Kaufman has directly taken on and rebutted all the arguments put forward by proponents of big banks – such as [Larry Summers of the White House and Hal Scott of Harvard Law School](#). Kaufman has the facts and most sensible opinion on his side, including the literature summarized in our book ([13 Bankers](#), which he cited yesterday), and other voices (also quoted in his speech yesterday):

1. Mervyn King, governor of the Bank of England: “Banks who think they can do everything for everyone all over the world are a recipe for concentrating risk.”
2. Alan Greenspan, formerly chair of the Federal Reserve Board: “For years the Federal Reserve had been concerned about the ever larger size of our financial institutions. Federal Reserve research had been unable to find economies of scale in banking beyond a modest-sized institution. A decade ago, citing such evidence, I noted that ‘megabanks being formed by growth and consolidation are increasingly complex entities that create the potential for unusually large systemic risks in the national and international economy should they fail.’ Regrettably, we did little to address the problem.”

With such strong arguments and powerful evidence on its side, you might think that the completely reasonable and responsible proposals in the SAFE Banking Act would get a vote. But you would be wrong.

The Senate leadership – on both sides of the aisle – has apparently decided that they do not want to give senators (and the public) the opportunity to focus their attention on this key issue. Instead, they would prefer to keep the “debate”, in terms of votes, on issues less likely to infuriate powerful banks.

Our democracy allows great freedom of discussion – and it is encouraging that someone as prominent as Senator Kaufman can take on (and trounce) the biggest banks on the merits of the case.

But how much is this freedom worth if the political power of the megabanks – based on campaign contributions, lobbying efforts, and more general ideological control – can effectively prevent an up-or-down vote in the US Senate on the most pressing issue of financial reform?

This is, of course, partly about the political power of corporations. But corporations are, in this sense, merely a veil – this is really all about which people have what kind of power in our society. To what extent are we really still a democracy – and how far have we already slipped [down the road to oligarchy](#)?

## Why Do Harvard Kids Head to Wall Street?

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The Baseline Scenario » 2010 » May 5/4/10 at 2:28 PM James Kwak

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*By James Kwak*

That’s the title of a [post a couple weeks ago](#) by Ezra Klein, in which he interviewed a friend of his who went to Wall Street after Harvard. Having seen this phenomenon from a couple of different angles, I’d say the interview is right on. This is how Klein summarizes the central theme:

“The impression of the Ivy-to-Wall Street pipeline is that it’s all about the money. You’re saying that it’s actually more that Wall Street has constructed a very intelligent recruiting program that speaks to the anxieties of the students and makes them an offer that there’s almost no reason to refuse.”

When I graduated from college, I had no interest in investment banking or its close cousin, management consulting. But I went to McKinsey for reasons that were only slightly different than those of the typical Ivy League undergrad;

after getting a Ph.D. in history, I discovered that I was unlikely to get a good academic job and was pretty much unqualified for anything else, and McKinsey was one of the few places that would hire me into a “good” job with no discernible qualifications (other than academic pedigree). Now that I’m at Yale Law School, where maybe 15% of students (my wild guess) come in wanting to be corporate lawyers but 75% end up at corporate law firms (first job after law school, not counting clerkships), I’m seeing it again.

The typical Harvard undergraduate is someone who: (a) is very good at school; (b) has been very successful by conventional standards for his entire life; (c) has little or no experience of the “real world” outside of school or school-like settings; (d) feels either the ambition or the duty to have a positive impact on the world (not well defined); and (e) is driven more by fear of not being a success than by a concrete desire to do anything in particular. (Yes, I know this is a stereotype; that’s why I said “typical.”) Their (our) decisions are motivated by two main decision rules: (1) close down as few options as possible; and (2) only do things that increase the possibility of future overachievement. Money is far down the list; at this point in their lives, if you asked them, many of these people would probably say that they only need to be middle or upper-middle class, and assume that they will be.

The recruiting processes of Wall Street firms (and consulting firms, and corporate law firms) exploit these (faulty) decision rules perfectly. The primary selling point of Goldman Sachs or McKinsey is that it leaves open the possibility of future greatness. The main pitch is, “Do this for two years, and afterward you can do anything (like be treasury secretary).” The idea is that you will get some kind of generic business training that equips you to do anything (this in a society that assumes the private sector can do no wrong and the public sector can do no right), and that you will get the resume credentials and connections you need to go on and do whatever you want. And to some extent it’s true, because these names look good on your resume, and very few potential future employers will wonder why you decided to go there. (Whether the training is good for much other than being a banker or a consultant is another question.)

The second selling point is that they make it easy. Yes, there is competition for jobs at these firms. But the process is easy. They come to campus and hold receptions with open bars. They tell you when and how to apply. They provide interview coaching. They have nice people who went to your school bond with you over the recruiting period. If you get an offer, they find out what your other options are and have partners call you to explain that those are great options, but Goldman/McKinsey is better, and you can do that other thing later, anyway. For people who don’t know how to get a job in the open economy, and who have ended each phase of their lives by taking the test to do the most prestigious thing possible in the next phase, all of this comes naturally. (Graduate schools, which also have well-defined recruiting processes, are the other big path to take.) The fact that most companies don’t want new college graduates makes it easier to go to one of the few that do.

The third selling point — not the top one, but it’s there — is the money. Or, more accurately, the lifestyle. The glossy brochures never say how much money you can make. But they make it clear that you will be part of the well-dressed, well-fed, jet-setting elite. When people walk into those offices, with fresh flowers and all-glass walls and free food and modern technology everywhere, they get seduced. Last summer one person wrote to my school’s email list about how wonderful his office was, with its view of Central Park. I mentioned this to an old friend who used to work at McKinsey, and he said, “he fell for the office.”

The same factors are also largely true for top law school graduates, although for them the money is understandably more important. Law school costs close to \$200,000 for three years, and I believe the average graduate has about \$100,000 in debt. So another major inducement is the idea that you will work at a corporate law firm for three or four years, pay off your debt, and then go work for legal aid or the U.S. attorney’s office.

But the other factors are also very important. If you go to a top law school, it is simply easier to get a corporate firm job than any other job. They all come to campus at the beginning of your second year, most people can get a job simply by following the interview process, you work there for one summer, and then you get an offer to come back. Even if you don’t want to work at a firm, it makes rational sense to do it for that summer to get the offer as Plan B.

By contrast, it’s hard to get a public interest job. Most public interest organizations don’t have the money to hire a lot of people, and many don’t want people right out of law school. So the usual route is you have to apply for a competitive fellowship to work at a public interest organization, and then you have to hope they’ll hire you for good after that year. It’s hard. And that’s how Plan B becomes Plan A. And besides, many prominent corporate lawyers have gone on to important positions in Washington, so there is still the possibility of future greatness.

And once you’re in the door, the seduction begins. As Klein’s interviewee says,

“When people leave law school with a lot of debt, they figure they’ll get some good skills and good money at a top-tier firm before going to save the world. But then you have a great apartment, more responsibilities, kids. You start enjoying it. It’s not even all material.

“And I think it’s important to point out, that things happen very quickly. Private equity firms were trying to recruit us in the first year of my two-year training program. There’s this notion of the accidental banker, people who get caught up in that world and get more and more pay and find it harder to justify leaving. But the cultural effect of all of this — and even with regulatory reform, we need to think about that — is that a lot of people decide to sacrifice much more time than they normally would because the money is so good, and then they believe they deserve extremely high pay because they’re giving up so much time. It’s not malicious. But there are a lot of unhappy people who end up in that situation.”

It’s just human nature. Your expenses grow to match your income. As the decades pass and you realize that no, you’re not going to save the world, the money becomes a more and more important part of the justification. And when you have kids, you’re stuck; it’s much easier to deprive yourself of money (and what it buys) than to deprive your children of money.

More importantly, you internalize the rationalizations for the work you are doing. It’s easier to think that underwriting new debt offerings *really is* saving the world than to think that you are underwriting new debt offerings, because of the money, *instead of* saving the world. And this goes for many walks of life. It’s easier for college professors to think that, by training the next generation of young minds (or, even more improbably, writing papers on esoteric subjects), they are changing the world than to think that they are teaching and researching *instead of* changing the world.

Sure, there are self-parodying, economically delusional, psychotherapy-needing, despicable people on Wall Street, like [this one](#). But there are also a lot of people who went there because it was easy and stayed because they decided they couldn’t afford not to and talked themselves into it.

A college student asked me at a book talk what I thought about undergraduates who go work on Wall Street. And individually, I have nothing against them, although I do think they should do their best to keep their expenses down so they will be able to switch careers later. But as a system, it’s a bad thing that a small handful of highly profitable firms are able to invest those profits into skimming off some of the top students at American universities — universities that, even if nominally private, are partially funded by taxpayer money in the form of research grants and federal subsidies for student loans —and absorbing them into the banking-consulting-lawyering Borg.

\* By the way, I think that even within the elite there is an inverse correlation between pay and quality of office; the banks make the most money and have the shabbiest offices, although that has been changing recently.

**Update:** I want to emphasize, if it isn’t clear from the above, that I don’t claim to be any better than people who do go to Wall Street. I worked at McKinsey, which is more or less the moral equivalent thereof (at least from the perspective of a new entrant to the job market), and for basically the same reasons. And I only left McKinsey because I went to an Internet boom-era software company, and I did that because it seemed even more prestigious and exciting (and potentially more lucrative, although that didn’t work out).

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## Download the Blog - New and Improved!

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The Baseline Scenario » 2010 » May 5/4/10 at 4:54 PM James Kwak

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*By James Kwak*

I finally came up with a better way to create a [downloadable blog archive](#) (always available via the “Download the Blog in PDF” link under Navigation in the right-hand sidebar). Now the archive is up to date (through April 2010) and you can download it in PDF, Kindle, or EPUB format. And it has clickable bookmarks for each individual post.

Thanks go to [Joss Winn](#), [Martin Hawksey](#), [Feedbooks](#), and Yahoo! Pipes. See the archive page itself for a technical description.

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## Mysterious Facebook Problems

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The Baseline Scenario » 2010 » May 5/4/10 at 10:09 PM James Kwak

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*By James Kwak*

Sometime this morning all of the links from our [Facebook page](#) back to the blog stopped working. According to



Facebook, “Facebook users” had identified the page as being “abusive.” I didn’t find out until this evening, when a reader emailed me. (I don’t spend a lot of time on Facebook.) When the problem started, it also applied to all of the older links from Facebook to the blog. The problem did not seem to affect links from the Facebook page to [13bankers.com](http://13bankers.com).

Then, in the last half our, the problem went away, and now all the links work.

I have no idea what happened. For background, this is what usually happens. New posts on this blog go into the RSS feed. That feed gets polled periodically by Twitterfeed, which takes the title of the post and the URL (compressed using bit.ly), appends “#fb”, and creates a new tweet from our [Twitter account](#). (The 13bankers.com feed gets treated the exact same way.) Then the Selective Tweets application for Facebook monitors our Twitter feed; whenever it sees a tweet that ends with “#fb”, it posts it to the Baseline Scenario fan page in Facebook.\*\*

The fact that the links to 13bankers.com continued to work seems to absolve Twitterfeed, bit.ly, and Selective Tweets. However, I have enough software experience to know that things are not necessarily that simple.

So the possibilities seem to be:

1. Facebook doesn’t like bit.ly — doubtful.
2. Facebook doesn’t like anything being promoted by Selective Tweets, as suggested by one commenter — quite possible. This could be a flaky problem, meaning it comes and goes. (It does seem like the problem appeared briefly on April 23 as well.)
3. Facebook has some kind of algorithm that says, “if the same site gets posted too many times using something that looks like an automatic process, it’s probably spam.” But this seems doubtful, since we are far from the biggest blog that auto-posts to Facebook.
4. A bunch of pro-Wall Street activists (are there such people? aren’t they called “lobbyists”?) figured out how to report to Facebook that baselinescenario.com is really a religious cult indoctrination site, and therefore someone at Facebook (or some program) shut off access to the site.

If anyone knows, or has better theories, please comment. If it happens again, someone please email us at baselinescenario at gmail dot com.

(Incidentally, ours is not the first blog this has happened to. This happened to [Cake Wrecks](#), a [blog](#) that highlights really, really bad cakes.)

\* Actually, I told Twitterfeed to use Snip instead of bit.ly, but for some reason it’s using bit.ly. But it’s been using bit.ly since long before this problem started.

\*\* I don’t use the main Twitter app for Facebook because, at the time I was setting this up, it didn’t allow you to post your tweets onto a fan page, only onto your personal Facebook page.

## More Ignorant Senators

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The Baseline Scenario » 2010 » May 5/4/10 at 11:37 PM James Kwak

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*By James Kwak*

So apparently a [JPMorgan Chase analyst](#) thinks that senators showed “an unnerving ignorance of fundamental principles of market economics.” Senator Charles Grassley went one better and showed an unnerving ignorance of how the government’s own budget works.

In a hearing on the administration’s proposal to recover the net costs of TARP through a tax on large banks, [Grassley said](#),

“If a TARP tax is imposed and the money is simply spent, that doesn’t repay taxpayers one cent for TARP losses. It’s just more tax-and-spend big government, while taxpayers foot the bill for Washington’s out-of-control spending.”

Grassley apparently thinks that when the government “spends” money, it doesn’t benefit taxpayers. What does he think the government does? Burn it? Give it to Martians?

Apparently according to Grassley, if the government uses the bank tax to cut other taxes or to pay down the national



debt, that would “repay taxpayers.” But if the government does any of the following, that is just taxpayers footing the bill for “out-of-control spending”:

1. Pay for Medicare benefits.
2. Pay for extended unemployment benefits.
3. Subsidize student loans.
4. Pay for veterans’ health care.
5. Pay for soldiers fighting in Iraq and Afghanistan.
6. Pay for Head Start teachers.

In 1, 2, 3, and 4, taxpayers get very concrete benefits by virtue of being old, unemployed, students, or veterans. In 5, the benefits are hard to quantify, but few people would say we should spend nothing on national security. I threw in 6 to be “balanced” — it’s something that most Republicans think the government should not be doing.

It is perfectly fine to have debates about the relative value of different forms of government spending. Some government spending counts as productive investments with a positive net present value (think of the interstate highway system, for example), some is pure transfer payments, and some is no doubt wasteful. But saying that when the government collects taxes and then spends tax revenues the people who paid those taxes get nothing in return is pure nonsense.

On the more important issue, I’m glad the administration is pressing for a large bank tax to recover the costs of TARP, because this will have the small effect of creating a disincentive to be large. But politically, it points out the problem with post-funding a bailout, which the administration favors. (The administration was against the Dodd plan to pre-fund future resolutions of large financial institutions.) The banks and their supporters are arguing that now is the wrong time to raise money from large banks, because that would crimp the economic recovery. This is precisely the reason why the funds should be raised before the crisis, during the boom.

## Expect Nothing

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The Baseline Scenario » 2010 » May 5/5/10 at 8:36 AM Simon Johnson

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By Simon Johnson, co-author of [13 Bankers: The Wall Street Takeover and The Next Financial Meltdown](#)

After months of denial, the European policy elite finally begins to understand that something is seriously wrong in the eurozone.

But the prevailing definition of the problem is still too narrow – the consensus in France and, even more, in Germany is that “this is a Greek problem”. Even the most negative still think that Portugal and Spain can easily escape serious damage.

This is a major misconception, [as we pointed out last week](#) – and as we have been emphasizing, to anyone who would listen, [for more than a year](#).

If you want to call for a “rescheduling” of Greece’s debts – a position that is becoming increasingly popular among leading north European intellectuals – that is fine. But you also need to recognize that the policy elite (central banks and ministries of finance) are completely unprepared to handle the consequences, which would be immediate and devastating for other weaker eurozone countries.

You simply cannot do a low-cost or small unilateral restructuring of government debt in this kind of situation; the market will at once take that as a signal that Portugal, Spain, Italy and perhaps even Ireland will face difficulties (in fact, this is exactly what spreads in the 2-year European government bond market are saying today). The French may smile upon such outcomes with a feeling of superiority, but they might also consider not throwing bricks in glass houses.

It is fine – even appropriate – to emphasize that big European banks have aided and abetted the irresponsible behavior of eurozone authorities. The profound stupidity of these banks-as-organizations is beyond belief, and it is deeply puzzling quite why [leading figures in the US Senate would see them as a model](#) for anything other than what we need to euthanize as soon as possible in the global financial system.

But do not fall into the trap of thinking just because “megabanks are bad” (undoubtedly true) that you can whack them with losses and not face the consequences – these people are powerful for a reason; they hold a knife to our throats. For all his [hubris, missteps, and over-reliance on Goldman group think](#), Hank Paulson had a point in September 2008:

If the choice is chaotic global collapse or unsavory financial rescue, which are you going to choose?

The Europeans will do nothing this week or for the foreseeable future. They have not planned for these events, they never gamed this scenario, and their decision-making structures are incapable of updating quickly enough. The incompetence at the level of top European institutions is profound and complete; do not let anyone fool you otherwise.

What we need is a new approach, [at the G20 level](#); this can definitely include debt restructuring, but it has to be done in a systematic fashion (and even then there will be a considerable degree of total mess). Such a change in framework for dealing with these issues will not get broad support until after further chaos in Europe, but it now needs to be put into place.

The Europeans will not lift a constructive finger. The leading emerging markets are too busy battenning down the hatches (and accumulating ever more massive chests of reserves). And the White House still seems determined to sleep through this crisis. Expect nothing.

## Financial Reform for the Long Term

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The Baseline Scenario » 2010 » May 5/5/10 at 11:45 AM James Kwak

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*By James Kwak*

The news these days is largely about the financial reform bill on the floor of the Senate. I think you know my opinion about that: many good things, not enough to solve the root problems, but still better than nothing.

Here's a simplified way of thinking about things. There are two general problems with the financial sector today, which were the subject of two consecutive columns by Paul Krugman. The [first problem](#), according to Krugman: "Much of the financial industry has become a racket — a game in which a handful of people are lavishly paid to mislead and exploit consumers and investors." This is what we see in the [SEC-Goldman suit](#), the [Magnetar](#) trade, and so on. The financial reform bill is largely (but not exclusively) aimed at this problem; that's why there are a consumer protection agency, new trading and clearing requirements for derivatives, etc. These reforms, I think, have a reasonable chance of doing good.

The second problem, again in [Krugman's words](#):

"The reforms currently on the table . . . only deal with part of the problem: they would make finance safer, but they might not make it smaller. . . .

"We've been devoting far too large a share of our wealth, far too much of the nation's talent, to the business of devising and peddling complex financial schemes — schemes that have a tendency to blow up the economy."

This is the long-term challenge (see my [charts here](#)). Finance is an intermediate input. At the margin, every little innovation that makes markets more liquid does provide a small benefit to the economy in the form of better capital allocation; but in many cases those benefits are not enough to justify their transaction costs, let alone the negative systemic externalities we saw recently. The flowering of finance in the past three decades gave us the illusion of growing real GDP — especially in the past decade, when GDP growth was dominated by finance and real estate. Now we need to rebalance the economy toward productive activities.

The bad news is that the administration and Democrats in Congress will face a strong temptation to pass the reform bill and declare victory. The conventional wisdom is that you don't get re-elected by saying, "We passed a bill that is pretty good, but doesn't solve the root problems, so we need to do more in the future." It's better politically to say you fixed the problem once and for all, then cross your fingers and hope for the best.

The good news is that there seems to be a growing number of voices saying that we need structural change in the financial sector. Besides Krugman and [Arianna Huffington](#), [Martin Wolf](#) has chimed in as well, arguing that making the current system safer, though necessary, is insufficient:

"The financial system would remain a doomsday machine. There are three difficulties. First, there is no sound basis for deciding how much capital is enough. Second, . . . it is profitable to take risks whose upside accrues to oneself and whose downside accrues to others. So the safer regulators try to make the system, the more risk it can take on. Finally, it is easy to create the desired risk via regulatory arbitrage."

Serious academic economics is also questioning the value of a large financial system. A paper by [Nicola Gennaioli](#).

[Andrei Shleifer, and Robert Vishny](#) (cited by [Krugman here](#)) shows how excessive production of securities (the phenomenon of the past decade) can be caused by mistakes in risk perception, making the financial system more fragile as a result. (As a another result, the social benefits of innovation can be outweighed by the social costs.)

So in the long term, I agree with Krugman: "These [current] reforms should be only the first step. We also need to cut finance down to size." Given that whatever comes out of Congress will be imperfect in anyone's eyes, whether the Obama administration agrees will be of crucial importance.

## It's Not About Greece Any More

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The Baseline Scenario » 2010 » May 5/6/10 at 6:06 AM Simon Johnson

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*By Peter Boone and Simon Johnson*

The Greek "rescue" package announced last weekend is dramatic, unprecedented, and far from enough to stabilize the eurozone.

The Greek government and the European Union (EU) leadership, prodded by the International Monetary Fund (IMF), are [finally becoming realistic about the dire economic situation in Greece](#). They have abandoned previous rounds of optimistic forecasts and have now admitted to a profoundly worse situation. This new program calls for a total of 11% of GDP in terms of "fiscal adjustments" (i.e., reduction in the budget deficit; now meaning government spending cuts mostly) in 2010, 4.3% in 2011, and 2% in 2012 and 2013. The total debt to GDP ratio peaks at 149% in 2012-13 before starting a gentle glide path back down to sanity.

This new program is honest enough to show why it is unlikely to succeed. Daniel Gros, an eminent economist on euro zone issues based in Brussels, has argued that for each 1% of GDP decline in Greek government spending, total demand in the country falls by 2.5% of GDP. If the government reduces spending by 15% of GDP – the initial shock to demand could be well over 30% of GDP. Obviously this simple rule does not work with such large numbers, but it illustrates that Greece is likely to experience a very sharp recession – and there is substantial uncertainty around how bad the economy will get. The program announced last weekend assumes Greek GDP falls by 4% this year, then by another 2.6% in 2011, before recovering to positive growth in 2012 and beyond.

Such figures seem extremely optimistic, particularly in face of the civil unrest now sweeping Greece and the deep hostility expressed towards Greece in some north European policy circles.

The pattern of growth is critical because, under this program, Greece needs to soon grow out of its debt problem. Greece's debt/GDP ratio will be a debilitating 145% of GDP at end 2011. If we put more realistic growth figures into the IMF forecast for Greece's economy, e.g., with GDP declining 12% to end 2011, then the debt/GDP ratio may reach 155%. At these levels, with a 5% real interest rate and no growth, the country needs a primary surplus at 8% of GDP to keep the debt/GDP ratio stable. They will be nowhere near that level. The IMF program has Greece running a primary budget deficit of around 1% of GDP in that year, and that assumes a path for Greek growth [that can only be regarded as an "upside scenario"](#).

The politics of these implied budget surpluses remain brutal. Since most Greek debt is held abroad, roughly 80% of the budget savings the Greek government makes go straight to Germans, French and other foreign debt holders (mostly banks). If growth turns out poorly, will the Greeks be prepared for ever tougher austerity to pay the Germans? Even if everything goes well, Greek citizens seem unlikely to welcome this version of their "new normal".

Last week the European leadership panicked – [very late in the day](#) – when they realized that the euro zone itself was at risk of a meltdown. If the euro zone proves unwilling to protect a member like Greece from default, then bond investors will [run from Portugal](#) and Spain also – if you doubt this, study carefully the [interlocking debt picture published recently in the New York Times](#). Higher yields on government debt would have caused concerns about potential bank runs in these nations, and then spread to more nations in Europe.

When there is such a "run" it is not clear where it stops. In the hazy distance, Belgium, France, Austria and many others were potentially at risk. Even the Germans cannot afford to bail out those nations.

Slapped in the face by this ugly scenario, the Europeans decided to throw everything they and the IMF had at bailing out Greece. The program as announced has only a small chance of preventing eventual Greek bankruptcy, but it may still slow or avert a dangerous spiral downward – and enormous collateral damage – in the rest of Europe.

The IMF floated in some fashion an alternative scenario with a debt restructuring, but this was rejected by both the

European Union and the Greek authorities. This is not a surprise – leading European policymakers are completely unprepared for broader problems that would follow a Greek “restructuring”, because markets would immediately mark down the debt (i.e., increase the yields) for Portugal, Spain, Ireland, and even Italy. The fear and panic in the face of this would be unparalleled in modern times: When the Greeks pay only 50% on the face value of their debt, what should expect from the Portuguese and Spanish? It all becomes arbitrary, including which countries are dragged down. Someone has to decide who should be defended and at what cost, and the European structures are completely unsuited to this kind of tough decision-making under pressure.

In the extreme downside scenario, Germany is the only obvious safe haven within the eurozone, so its government bond yields would collapse while other governments face sharply rising yields. The eurozone would likely not hold together.

There is still a narrow escape path, without immediate debt default and the chaos that would produce:

1. Talk down the euro – moving towards parity with the US dollar would help lift growth across the eurozone.
2. As the euro falls, bond yields will rise on the eurozone periphery. This will create episodes of panic. Enough short-term financing must be in place to support the rollover of government debt.
3. Once the euro has fallen a great deal, announce the ECB will support the euro at those levels (i.e., prevent appreciation, with G20 tacit agreement), and also support the peripheral eurozone nations viewed as solvent by buying their bonds whenever markets are chaotic.
4. At that stage, but not before, the eurozone leadership needs to push weaker governments to restructure – that will include Greece and perhaps also Portugal? Hopefully, in this scenario Spain can muddle through.
5. European banks should be recapitalized as necessary and have most of their management replaced. This is a massive failure of euro groupthink – including most notably at the political level – but there is no question that bank executives have not behaved responsibly in a long while and should be replaced en masse.

To the extent possible, some of the ensuing losses should be shared with bank creditors. But be careful what you wish for – the bankers are powerful for a reason; they have built vital yet fragile structures at the heart of our economies. Dismantle with care.

*An edited version of this post appears this morning [on the NYT's Economix](#) and is used here with permission. If you wish to republish the entire article, please contact the New York Times.*

## Brown-Kaufman Amendment: The State Of Play

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The Baseline Scenario » 2010 » May 5/6/10 at 8:44 AM Simon Johnson

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By Simon Johnson, co-author of [13 Bankers: The Wall Street Takeover and the Next Financial Meltdown](#)

When you strip away the disinformation, false promises, and wishful thinking, this is where we are on really reigning in the power of the country's largest – and most dangerous – banks.

Senators Sherrod Brown and Ted Kaufman have [proposed the SAFE Banking Act](#), which is an entirely reasonable and responsible way of limiting the size of our largest banks. It should be adopted as an amendment to the main financial reform bill now before the Senate.

As the *New York Times* points out today, there is [growing support for this approach](#). But note that this article – while entirely accurate – was relegated to page B3; Sewell Chan's original piece on this topic [was a front page story](#) on April 20.

The opposition to Brown-Kaufman at the highest levels of government (legislature and executive branches) is so strong that it is increasingly unlikely the amendment will even get an up-or-down vote on the Senate floor.

The NYT's editorial page has [endorsed Brown-Kaufman](#), as have a growing number of organizations that want to see some meaningful financial reform.

But opposition to Brown-Kaufman (and actually any real reform) is deeply entrenched [among prominent senators and](#)

[even the White House](#). They fall back on increasingly specious arguments, completely unencumbered by the evidence or any real head-to-head debate.

These people may well be soon forgotten – or even as widely disparaged in a few years as the once-ascendant Robert Rubin and Alan Greenspan are today. But for the moment their power on Capitol Hill is almost unbreakable.

This is not about ideology any more – it is hard to find anyone who will argue in public that finance is always good, unfettered finance is better, and largely unregulated big banks are the best. This is a major and encouraging break from the history of the past 30 years – as told, for example, in *13 Bankers*.

The revolving door between Washington and Wall Street is also playing less of a role than in the past (again, we review the recent decades of evidence in *13 Bankers*). To be sure, there are still plenty of lobbyists with Capitol Hill experience, but it is no longer fashionable for a top senator or treasury official to go easy on big banks and then slip into a comfortable boardroom for well-remunerated slumber (talk to Robert Rubin or Phil Gramm). We may see some of this, of course, but any such individuals will be pilloried indefinitely and without mercy; their names will live in serious infamy.

The lack of debate over Brown-Kaufman – and its likely demise – is all about money. There is a tsunami of contributions from the financial sector washing over Congress right now. When the dust settles, the pattern will be clear: Wall Street (legally) bought off key senators.

There will be a reckoning, to be sure, at the polls. The supporters of big banks will go down hard in November and in 2012; there are no secrets over this kind of time frame. But by then it will be too late for this cycle of financial reform – and there is no guarantee that the backlash will bring stronger reformers to power (in fact, the White House and the biggest banks would be quite happy to see non-reformers prevail.)

[Call your senator](#), by all means, and urge support for Brown-Kaufman – or at least press them to allow a Senate floor vote on the issue.

Recognizing the paramount importance of money at this moment, you might also offer to send a \$2 bill to every senator who votes for Brown-Kaufman.

If you haven't seen the \$2 in a while, stop by the bank and get one. Even if there is never anyone to whom it is worth sending, you can always pin it up in your kitchen as a reminder of what went wrong. It will be up to you which side to look at more often: Thomas Jefferson, who argued so powerfully against the dangers of a financial aristocracy (see chapter 1 of *13 Bankers*); or the signing of the Declaration of Independence.

**Update: [Tiffiny Cheng has a “whip count”](#) and suggestions regarding how to sharpen everyone's focus on key senators**

## **[“A Process That Only We Fully Understand”](#)**

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The Baseline Scenario » 2010 » May 5/6/10 at 2:11 PM James Kwak

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*By James Kwak*

Bernie Sanders's [“audit the Fed” amendment](#), which expands the ability of the Government Accountability Office to review Federal Reserve operations, seems to be [gaining some momentum](#). Opponents, including the Obama administration and Fed chair Ben Bernanke, are mounting a defensive effort. There are two main arguments that I have heard.

The first is that publicizing which banks take advantage of Fed lending facilities will stigmatize those banks and could increase panic in the midst of a financial crisis. I'm not particularly convinced by this argument, since most supporters of the amendment are fine with releasing such information with a delay. Section 1152(a)(2) of the amendment eliminates the provision in 31 U.S.C. 714(b) that shields from audit monetary policy decision-making and financial transactions by Federal Reserve banks, but replaces it with this:

“Audits of the Federal Reserve Board and Federal reserve banks shall not include unreleased transcripts or minutes of meetings of the Board of Governors or of the Federal Open Market Committee. To the extent that an audit deals with individual market actions, records related to such actions shall only be released by the Comptroller General after 180 days have elapsed following the effective date of such actions.”

Transparency is supposed to be *good* for markets, because it gives parties in the market the information they need in order to make rational decisions. I understand the concern that immediate disclosure could make banks avoid using Fed lending facilities in a crisis, which could be bad. But I don't see why the 180-day delay doesn't solve this problem. Let's say (for argument's sake) that Goldman Sachs borrowed money from a Fed liquidity program in May 2008. If they can't bear the market receiving this news in November 2008, doesn't that imply that they really are in big trouble, and the market should know about it? In other words, Goldman and the Fed have six months to solve whatever problem Goldman had. If they can't solve it by then, then Goldman is no longer worth protecting.

The second argument is that increased GAO oversight will unduly "politicize" or "interfere with" monetary policy. On its face, this objection doesn't seem to apply, since the amendment would explicitly *not* bring to light transcripts or minutes of meetings that the Fed had not itself already released.

More fundamentally, though, this objection rests on a disturbing view of how government should operate. Equating *information* with politicization or interference is a misleading way to justify undemocratic processes. In general, government agencies are supposed to be overseen by Congress (of which the GAO is an arm). As a basic principle, it's good that the people's elected representatives have visibility into what the other arms of the government are doing, so that they can make better decisions about, for example, whether heads of regulatory agencies should be reconfirmed, or whether the statutes governing those agencies should be modified. We even have Congressional oversight over deeply secretive operations, such as our intelligence operations. If "politics" means accountability to officials who are actually accountable to the people, then that's a good thing.

There is a lot of skepticism about Congress these days, and that skepticism is justified. But the alternative — allowing government agencies to operate in secret because we think our Congressional representatives are bozos — is worse.

But the Fed is different, people say. Monetary policy is so technical, and so hard to explain to the public, and so dependent on the credibility of the central bank, that any exposure to politics would be dangerous.

The idea that monetary policy is too technical for Congress to understand, and therefore should be done in secret, I don't buy. So is, say, climate policy. That's a complex scientific topic, of crucial importance to the future of our nation (and the human race), that is clearly beyond the ability of Congress to understand and discuss responsibly. But we don't exempt the EPA from Congressional oversight.

The idea that monetary policy, to work at all, must be sealed off from political interference has a little more merit to it. The idea (to simplify) is that elected politicians always want to lower interest rates in order to boost growth and jobs; in order to maintain inflation-fighting credibility, central banks have to be completely apolitical, and the markets have to believe that they are apolitical. But from there to the idea that there must be a blanket of secrecy over all decision-making is much too large a leap.

[Ryan Grim's article](#) discussing Federal Reserve transcripts from 2004 is especially instructive in this context. The article focuses on a meeting of the Open Market Committee at which there was debate about whether there was an unsustainable housing bubble. The minutes of that meeting, released the same year, whitewashed the debate. More revealingly, the recently-released transcript includes this gem from Alan Greenspan:

"We run the risk, by laying out the pros and cons of a particular argument, of inducing people to join in on the debate, and in this regard it is possible to lose control of a process that only we fully understand."

That is the money quote of this whole debate about the Fed, and I'm sorry I buried it 750 words into this post. (I'm not a news reporter, as you no doubt know.) The Fed and its defenders think that monetary policy should be entirely up to them — which it is — and that no one else should even participate in the debate. They are so concerned about this prerogative that they react violently even to suggestions that Fed policy-making should be reviewed after the fact.

This goes hand-in-hand with the idea that the Fed chair is a *de facto* dictator and that even questioning him is economic treason. We saw this during the Bernanke reconfirmation debate, when supposed experts and Wall Street insiders claimed that, were Bernanke to be voted down, the markets would collapse. I think this claim is almost certainly false, but if it were true that would be even worse: how can it be a good thing that our economy is held hostage to the health of a fifty-six-year-old man? (And Greenspan was seventy-nine when he stepped down.)

Look, we all know there are debates about monetary policy. Intelligent economists have them all the time in public, and Federal Reserve bank presidents have them as well through their public appearances (though in somewhat measured tones). We all know what the arguments on the various sides of those debates are. What we gain by trying to hide them and pretending they don't exist — except for increasing the dangerous mythology of the omniscient Fed chair — is beyond me.

Monetary policy is important. It is also somewhat technical. It should not be decided by vote of Congress every six

weeks. That's why we entrust it to a committee of twelve people, seven of whom are presidential appointees confirmed by the Senate and five of whom are bank presidents chosen by boards of directors themselves chosen (in a majority) by private banks. Their actions (raising or lowering key rates) are announced the same day that they meet, and commentators jump all over them immediately. The idea that Ben Bernanke would do something he thought was bad for the economy because he was afraid of what a GAO report might say about his decision-making process (remember, the decision is public immediately) is both preposterous and, frankly, insulting to Ben Bernanke.

I don't actually think auditing the Fed is the most important step we need to take to fix our financial system. And I am open to considering alternatives to the Sanders amendment, if any serious ones were to be put forward. But hiding behind the idea that the Fed is so magical that it has to be hidden from the people it serves is about as undemocratic as it gets.

PS: In Chapter 6 of their forthcoming *Crisis Economics* (I got a free advance copy from Roubini Global Economics), Nouriel Roubini and Stephen Mihm discuss how the Fed's role changed during the recent crisis — from a traditional “lender of last resort” model to an “investor of last resort” model in which the Fed bought up all kinds of non-traditional assets (e.g., long-term Treasuries, agency bonds) in an attempt to stop the economic downturn. Roubini and Mihm are generally positive about the short-term impact of these policies. But, they argue, by taking the Fed far afield from its traditional scope of action, they raise the issue of democratic accountability:

“The Fed has instead stepped into the financial system and effectively subsidized its operations, potentially incurring losses that could ultimately fall on the shoulders of taxpayers. Put differently, it's engaging in monetary policies that bleed imperceptibly into the traditional domain of fiscal policy — namely, government's power to tax and spend. Those are prerogatives of the legislative branch, but in this crisis Bernanke's policies have blurred that line.”

In another passage, they refer to this as “an end run around the legislative process.” This, it seems to me, strengthens the argument that increased oversight of the Fed is warranted.

PPS: [Brad DeLong](#) has an argument against the Sanders amendment. But his argument seems to be that the Sanders amendment does not solve the real problems with the Fed:

“I do not think that the Federal Reserve is working reasonably well. I do not think that the dominant views of monetary policy in the FOMC right now are informed by American values and a reality-based assessment of the state of the economy. That a good many of the people speaking and voting in the FOMC are the wrong people to do so did not matter (much) when the Federal Reserve was dominated by the incredibly charismatic (yes, I mean that) philosopher-central banker-princes of William McChesney Martin, Arthur Burns, Paul Volcker, and Alan Greenspan, but it matters now.”

I'm not sure DeLong makes a strong case in his post that the Sanders amendment is actually bad — just that the Fed's problems go deeper than those that will be solved by greater oversight.

## The Agenda For Emergency Economic Strategy Discussions This Weekend

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The Baseline Scenario » 2010 » May 5/7/10 at 8:57 AM Simon Johnson

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By Peter Boone and Simon Johnson

Europe needs a new recovery plan, bigger and broader than anything put together so far. This weekend is the perfect time to put such a plan together. But be wary of committing official resources too early in this market downdraft — smart policymakers will calmly let the markets fall further, in order to benefit from the rebound potential.

In the last few days, bond markets have decided that the deflationary adjustments — cutting wages and prices — needed in large parts of the eurozone are not politically feasible. The deflationary spiral that will come with fiscal cuts causes political turmoil and reduces revenues — that in turn makes it ever harder to service debt; see Greece this week. Eurozone countries running large budget deficits with substantial outstanding public debt are finding they are cut off from credit markets as a result. This is a solvency issue, not a liquidity issue.

But do not rush into this gap. If the European Central Bank (ECB) were to start buying Spanish debt today, for example, they would find an abundance of sellers because the bonds are fundamentally overvalued.

There is a good rule for foreign exchange intervention: you intervene to buy a currency at a time when you think you can really shift events — i.e., when the exchange rate has fallen more than really makes sense and shorting the



currency has become overly fashionable. In that way you cause traders with short positions to lose a considerable amount of money, and you draw in real buyers who want to own the assets because they are inexpensive and can now see an end to the declines.

We are not yet at that point in the bond markets for weaker eurozone countries or in the foreign exchange market for euro.

Start with bonds: [Greece clearly must end up restructuring its debt](#). The IMF program makes that obvious – how can Greece make a total of 19% of GDP in cuts, only to end with 149% of GDP in debt, and a perpetual bill to pay German, French, and other foreign holders roughly 10% of income each year just to cover interest?

This is a political disaster for all concerned and should be cleaned up now rather than left to ferment. The markets, with their high interest rates on Greek debt, show they believe this is the outcome. The market prices in about a 29% chance that Greece's default within one year, and 35% over two years (assuming a 40% recovery rate on Greek bonds after default and restructuring).

Portugal should restructure preemptively – they have a large budget deficit and current account deficit, and will have similar problems cutting the budget deficit. When the government takes fiscal austerity measures, unemployment will rise further, the economy will slow, so revenues will fall, and that will mean they make too little progress bringing in their deficit.

Spain is in a very difficult position. It is unlikely they can avoid restructuring for the same reasons as Portugal and Greece, but they are starting from a position with less public debt outstanding (if the numbers are correct). However, Spanish banks own a great deal of Portuguese debt, so if Portugal restructures it poses a major additional burden on Spain.

Italy and Ireland are clearly in trouble also, depending on exactly how expectations for eurozone growth are revised downwards. Given all these nations probably need to restructure their debt, or have large bailout packages that may not succeed in any case, we cannot expect bond markets to rally at this time. "Investment grade" investors, finally waking to the problems in the market, now fear holding these bonds.

The traditional holders of these bonds, such as AXA the French insurance group, or German Commerzbank, are telling investors exactly how much risk they have in Portugal-Ireland-Italy-Greece-and-Spain. The true message is: "We promise we will not buy more of the these countries' debt". Without the traditional investors available, who is going to finance Spain, Ireland, Italy, and Portugal's ongoing large budget deficits?

And this is the next problem. This week the [EU commission released its forecasts](#) for budget deficits in 2010 and 2011. Those were a depressing set of numbers. They expect Europe will grow by less than 1% this year and only 1.5% in 2011. Meanwhile, budget deficits would hardly change. Ireland leads the pack (in a bad sense) with a 11.7% of GDP budget deficit in 2010 and 12.1% in 2011. Greece, Portugal, Spain are all in the same range – large budget deficits and little improvement on the horizon. These are unrealistic plans given the lack of buyers for their bonds. Careful study of the details will only exacerbate concerns about fiscal solvency.

What should economic policymakers – in Europe, the US, and elsewhere – do about all this, for example as they convene in emergency meetings this weekend?

First, the core problem is that the euro zone as currently designed is a failure. It has proven wrong to blend so many disparate nations into one currency, and then manage the currency according to relatively hawkish German preferences.

This is an unfortunate loss of face for the eurozone policy elite, but they need to get over this and move on.

The euro zone in its current form needs to be wound down, most likely being reduced to a core of countries that are sufficiently similar – and without the presumption that others will soon be admitted. The weaker countries badly need currencies reflect their national fundamentals. Germany does not need a weak currency, but Greece, Portugal, Ireland and Spain today do.

A depreciation of the euro against the dollar and other major currencies would help. But these nations trade more with each other more than with non-euro countries, so they need to change competitiveness relative to each other.

Even if by a miracle the worst outcomes are now averted, what will prevent problems like this from happening again if the euro zone stays in place? The euro authorities have demonstrated repeatedly they are incapable of regulating banks well at the eurozone or EU level – it is unimaginable that the 16 eurozone countries could get together around a table and declare that any one regulator has been seriously derelict.

The planned budget reforms at the EU level will push towards more discipline, but you need an incentive structure to get that and the consensus-based decision-making does not work for that. If this weekend only produces a reaffirmation of platitudes in this regard, next week will be very bad. This is fiddling while cities burn.

On top of all this, shocks to economic performance that are different across nations will persist. Sharing one currency across these very different and insufficiently convergent countries simply does not make sense.

Second, there needs to be an orderly plan for debt restructuring across the euro zone. This needs to be done quickly (this weekend works, but realistically it will take several weeks), while the exit to a new currency could take longer. Since most euro zone nations bonds are issued under domestic law, such restructurings should be able to proceed quickly (in emerging markets, most of the bonds are often under US or UK law, which generally makes restructuring much harder).

But do not think that Greece can restructure its debts without having broader repercussions. All the weaker eurozone countries must proceed together on this front or there will be chaos.

Third, the G20 needs to assist in the euro restructuring project. This body can authorize the International Monetary Fund to help each affected nation declare a standstill on debt, and then draw up a plan to restructure debt. The IMF should play a key implementation role in helping to decide which nations should restructure their debts and then support this process – not because it is particularly good or suited to this task, but simply because no one else is available.

During the next few years each troubled euro nation will need liquidity support from the ECB, and they will need fiscal financing from the IMF and core nations in the EU. Probably the G20 should commit more resources, at least as a back stop. These programs can be drawn up quickly, and, they should include a transition to a new currency where appropriate.

There is no real leadership in the EU, combined with complete unwillingness to admit the fundamental error of the euro zone itself. The Germans are happy to let other nations suffer for their past mistakes, so they will do nothing until there is a more complete crisis.

The ECB, as witnessed by Mr. Trichet's news conference on Thursday, has decided that they will play the hawk, and so offer nothing of support to the nations in the periphery. Meanwhile, bond markets have closed for the periphery. This can only mean bond yields keep rising, there are runs on the banks in many nations, and then eventual economic collapse. This, unfortunately, is the path of least resistance for all parties.

So, someone needs to take leadership. Who can do this? Not the IMF by itself – it is too weak and conflicted with Dominique Strauss-Kahn clinging to his position as managing director (against increasing pressure from the United States). Indeed, Strauss-Kahn should leave the IMF so he can launch his run for the French presidency – it would be appropriately ironic if he were to win; as an architect of the eurozone, he is the perfect person to dismantle it. A much more [independent person with international stature should replace him](#).

President Obama needs to step in personally to help this process work smoothly. The president can rightly claim that this is an international issue, not just a euro zone issue, since it impacts global trade and financial stability. All the world's large banks are closely linked through debt, derivatives contracts, and other finance.

It would be irresponsible to presume that American banks will smoothly sail through the impending financial collapse in the euro zone. If this is left to the Europeans, as we learned this week in markets, there is a clear danger that Europe's problems will topple the world into a new recession and a serious round of financial instability this year.

Someone needs soon to bring clarity and restore confidence. If not President Obama, who?

## Falling Back On Waterloo

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The Baseline Scenario » 2010 » May 5/7/10 at 9:56 AM Simon Johnson

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By Simon Johnson, [13 Bankers: The Wall Street Takeover and The Next Financial Meltdown](#)

The bank lobbyists have the champagne out – the [Brown-Kaufman amendment](#), which would have capped the size and leverage of our largest banks – was defeated in the Senate last night, 33-61. Feeling ascendant, the big banks swarm forward to take on their next foe – [the Kanjorski amendment](#) (that would greatly strengthen the power of

regulators to break up megabanks), which they plan to gut in the backrooms.

This is overconfidence – because the consensus against them is beginning to shift significantly. Partly this is the result of great efforts by Senator Ted Kaufman, Senator Sherrod Brown, and their colleagues over recent months and weeks. Partly this is due to all the people who [came on board and pushed hard](#).

But, as in many such cases, it is also a question of luck – and timing.

The European sovereign debt crisis is deepening. And the picture that is worth many thousands of words is the NYT's graph of [interlocking debt within the eurozone](#).

As far as anyone can ascertain, this is almost all debt held by banks (often then “repo-ing”, or borrowing against it as collateral, at the European Central Bank.)

In other words, the European megabanks – lauded by Senators Dodd, Corker, Warner and others as a model for us to follow – are up to the eyeballs in bad debt. Their governance has completely failed. Their regulatory systems have been gutted – on their way to being turned into ash.

None of this would matter, of course, if the eurozone policy elite had its act together and could terminate its current position with minimal losses. But it cannot – [the deer are in the headlights](#).

Ask everyone this question: Which are the huge global banks that Senator Dodd, Jamie Dimon, and Larry Summers think we should be emulating? Surely not the Chinese – their governance failures are profound and complete; this is state banking run amok. Surely not the British – after all Mervyn King and Adair Turner, the top authorities on those banks, are globally the most articulate officials on how good finance has gone so deeply wrong. Surely not the Canadians – those [myths have been long exploded](#) (and without dissent, in our conversations with the Bank of Canada).

And surely you are not proposing that the continental European banks are a model of anything other than ineptness, blind herding, and the transition from being “too big to fail” to “so big that even when you save them, you get an economic catastrophe”?

To the victors last night in the Senate: congratulations – your opponents have fallen back. Your generals are known to be invincible, your forces are the best, and your resources are without limit.

And so we wait for you again, on a gentle slope and behind a ridge – appropriately enough with our backs to Brussels. [Welcome to Waterloo](#).

## Email Updates

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The Baseline Scenario » 2010 » May 5/7/10 at 10:18 AM James Kwak

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*By James Kwak*

These were down for the past few days. I think it is related to something I did to [create the PDF archive](#) a few days ago. I switched the setting back yesterday so I'm hoping the email updates will be back as of this evening.

## Bye-Bye, Facebook

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The Baseline Scenario » 2010 » May 5/9/10 at 6:47 PM James Kwak

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*By James Kwak*

I recently deleted most of my personal information in my Facebook account. (I am keeping the [Baseline Scenario page](#) up for the convenience of people who want to read the blog within Facebook, and I need to have my personal account in order to manage that page.) This is only a tiny bit related to the fact that, for several days recently, Facebook was [blocking access to this blog](#). It's mainly because I've decided that the costs of Facebook outweigh the benefits.

First, take a look at this [fantastic graphic](#) by Matt McKeon (hat tip [Tyler Cowen](#)). You have to click on it to advance

through time; it shows what information is, by default, available to whom, and how that has changed over time. (Click on the link to the “image-based version” if you’re having trouble.) Then come back here.

In short, there has been a massive, one-directional shift in how much of your information is visible by default either to everyone on Facebook, or to everyone on the Internet. Now, the usual defense of Facebook is that this is only by default; you can control information access via your privacy settings, which have gotten more fine-grained over time.

But this argument doesn’t fly for me. First of all, there is the problem that many people don’t realize they have this control and don’t use it. Second, finding and using those privacy settings is not trivial. But for years, I figured that I was savvy and careful enough to protect myself adequately. I’m not that paranoid about personal information on the Internet to begin with—there are various versions of my biography already floating around—and besides, I worked in the software industry for eight years (some of that time helping to design and configure software, not just market and sell it), so I should be able to figure this stuff out.

But I can’t, at least not in the amount of time I’m willing to dedicate to the problem. Recently, Facebook made yet another structural change. Before, information about where you used to go to school or work was simple text fields in your profile. (I’m *not* talking about networks here; I’m talking about the “education and work” section of your profile.) Then Facebook switched it so that each prior school or job became an active link to a new “community page.” (There’s no option to have a simple text field anymore.) These community pages appeared to aggregate posts (formerly status messages) made by community page members that were “related” to the topic of the community — meaning that the name of the community (e.g., “Yale Law School”) appeared in the text of the post. I could see lots of posts by people I have no apparent relationship to. I checked the privacy settings, and there was no new switch for community pages, so I couldn’t tell how the filtering was working. Maybe I was only seeing posts from people who let me see them by virtue of being in the same network (or people who let all of Facebook see their information), but I’m not sure. And nowhere does Facebook clearly explain how their privacy filtering works.

(It turns out this “feature,” which goes by the name of Facebook Connections, is even more frightening than I thought, according to the [Electronic Frontier Foundation](#). Here’s #4 of six warnings:

**“Facebook will continue to store and use your Connections even after you delete them.** Just because you can’t see them doesn’t mean they’re not there. Even after you ‘delete’ profile information, Facebook will remember it. We’ve also received reports that Facebook continues to use deleted profile information to help people find you through Facebook’s search engine.”

But I only found that out when doing research for this blog post. People shouldn’t have to do third-party research on the web to understand how to use Facebook.)

Of course, this isn’t the first time Facebook has unleashed a privacy-affecting change to the way it organizes information. There was [Beacon](#), a “service” that took information about what you did elsewhere on the Web and published it to Facebook. Not only that, but Beacon was even harvesting information that Facebook executives did not realize it was harvesting ([Wikipedia](#); [original source](#)).

Beacon is very old news. But it points out two things about Facebook that I don’t think have changed. First, Facebook doesn’t care about its customers. It has a huge and largely loyal customer base, so it must be doing something right. But it is primarily concerned with the need to generate revenues from that customer base, and as a result it is constantly experimenting with new programs that may enable it to earn money. Facebook should know that a large minority (if not majority) of its users are concerned about privacy and do not like these unannounced, poorly explained changes to how their information is used.

Second, Facebook is just bad software. This manifests itself in various ways. The performance (speed of response) for many user actions is terrible. The user interface manages the improbable dual achievement of being both non-intuitive (it’s not obvious why the page is organized the way it is, nor how Facebook classifies different kinds of information, nor how to do rather simple things) and under-functional (you have to click and click and click to do certain things, like un-liking a fan page, leaving a group, or deleting an application).

And it’s worse than that. Last week, [TechCrunch](#) reported a “security hole” that allowed to see their friends’ live chats and pending friend requests. Now, you may think, “Windows has thousands of security holes — what’s one more?” But this isn’t a securities hole in the Windows sense, meaning a vulnerability that a malicious hacker might exploit. This is a flaw that Facebook inflicted on itself, all by itself, that was sitting there waiting for any ordinary user to find.

Then there’s the problem that Facebook marketing, and Facebook executives, are unable to explain clearly what exactly their software does. That could be studied vagueness in order to obfuscate. Or it could be that their data model, user model, and security model are so screwed up after several years of experimenting that they don’t actually know what is going on: they make changes to the software, cross their fingers, and use their customers as testers. I

would bet on the latter.

This is what happens when software grows and grows over several years. It's especially what happens when the software evolves far from what it was initially designed for, without a plan for how it should evolve, as is clearly the case with Facebook. And it's what happens when you have a company that is growing much too fast, under too much pressure from investors, competitors, and the outside world.

The people who run Facebook may or may not be evil. And I imagine that they will continue to be very successful; I have never been a good predictor of what technologies or companies will do well. But in any case I don't think they're very good at writing software. And I don't want to devote my time to figuring out what Facebook may or may not be doing (knowingly or accidentally) with my information.

As I said above, I'm keeping the Baseline Scenario fan page for the convenience of Facebook users who happen to like this blog, and I need to have a personal account for that purpose. But from now on I'm erring on the side of non-disclosure.

## Eurozone: The Kitchen Sink Goes In - Now It's All About Solvency

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The Baseline Scenario » 2010 » May 5/10/10 at 6:00 AM Simon Johnson

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*By Peter Boone and Simon Johnson*

The eurozone self-rescue plan announced last night has three main elements:

1. 750bn euros in a fiscal support program, with 1/3 coming from the IMF (although this was apparently [news to the IMF](#)).
2. The European Central Bank promises to buy bonds in dysfunctional markets.
3. Swap lines with the Federal Reserve, to provide dollars.

At first pass this package might seem to be in with what we recommended [a week ago](#) and [again on Thursday](#).

But the European central banks have come in very early – with government bond prices still high – and there is no sign yet of credible fiscal adjustment for Spain and Portugal. The eurozone apparently did not even discuss the situation in Ireland, which seems increasingly troubling.

This is a whole new level of global moral hazard – the result of an alliance of convenience between troubled governments in the south of Europe and the north European banks (and implicitly, north American banks) who enabled their debt habit. The Europeans promise to unveil a mechanism this week that will “prevent abuse” by borrowing countries, but it is hard to see how this would really work in Europe today.

Overall, this is our assessment:

The underlying problem in the euro zone is that Portugal, Ireland, Italy, Greece, and Spain are locked into a currency which means they are uncompetitive in trade terms while they are also running large budget deficits. To get out of this they need large wage and price cuts to restore competitiveness, and they need to make fiscal cuts to get budget balances back at sustainable levels.

Markets decided these adjustments were going to be difficult, so spreads on those countries' debts widened (i.e., interest rates relative to German government bonds). As the rates go up, this causes local asset prices to fall, concerns over bank balance sheets increase, etc. This combination was causing an incipient run on banks. Any country with its own currency could reasonably devalue in such a situation, but this is not an option within the euro bloc.

All these problems were exacerbated by the appearance that the Germans were going to be unwilling to bail out troubled nations – and would eventually chose to bail out their own banks instead. It is this risk which is now resolved. The Germans have shown willingness to provide very large amounts of money (the 750bn euro support is probably just enough for Spain and Portugal if they got packages in line with that received by Greece) and they would obviously provide more if needed (e.g., for Italy). (Here again is the ready reckoning chart for [interlinkages between indebted Europeans](#).)

However, the solvency issue remains. The Spanish and Portuguese have said they will now cut their budgets further, but already their forecasts were optimistic, and neither has seemed willing to admit they have severe budget

problems, so we will need to watch how they implement in the near term. Greece [remains simply far too indebted](#).

As Willem Buiter (formerly Bank of England, now at Citigroup) remarked last week, you have the greatest incentive to default when you are running a balanced primary budget (i.e., after substantial budget cuts) and still have a large government debt outstanding. His point is that the incentive structure of these programs means they will postpone a decision to default which would otherwise be rational now.

There is no discussion of Ireland, which has one of the highest deficits of all the EU nations. This is a vulnerability to the European Stabilization Mechanism – more countries will flock to its embrace.

There is a more subtle issue with the seniority of debt. The EU packages to these countries are all senior to existing creditors. These creditors know therefore that countries which need packages will get senior funds from the IMF and EU, and, therefore recovery values for bonds will be less.

This is perfectly fair since packages come when no one else will lend, but it explains why packages do not reduce secondary market yields as low as people would expect. The yield on Greek bonds needs to stay high given the risk that the bonds could have 70% writedowns if the likely default does happen. The same is true, to a lesser extent, for Portugal, Ireland and Spain. All of these might eventually need to access the 750bn euros and might eventually default. Bond market yields need to stay high.

The decision by the European Central Bank (ECB) to intervene in the markets is very important. That will help keep markets liquid – but the ECB will probably not buy a lot of debt.

Will the ECB buy a great deal of Greek debt? We doubt it since this constitutes a clear, large credit risk. But it will be interesting to watch. If the ECB is not large in the market they will not impact spreads beyond reducing the liquidity risk premium. Today most of these nations have substantial default risk over 5-10 years, so spreads need to stay high – although they will come in from current levels.

The European Central Bank intervention and this package raise enormous moral hazard issues. The ECB's management was forced into this kicking and screaming. It was only when they realized that the whole euro zone financial system was at risk of collapse that they threw the kitchen sink at the problem. This can now go two ways: either they tighten fiscal policy across the eurozone, and introduce much more rigorous and enforced rules on deficits and profligate credit through banks, or, they let a system persist which is another “doomsday machine” that will live again to grow, and could one day topple them.

To ultimately get out of this mess, the euro zone needs to grow fast enough to allow nations to grow out of debt. The global backdrop here is very positive in the short term. The jobs numbers in the US last week and strong numbers out of core northern Europe suggest the world can grow. No doubt the ECB and the Fed will use the eurozone scare to justify longer loose policies.

It could be that in two years time Europe's deficits are much lower, the ECB has hardly bought any bonds, and they have successfully managed a Greek debt restructuring while Spain is out of trouble, and Portugal and Ireland are scraping by in limbo but now isolated problems. With the US likely to still be running near 10% GDP budget deficits – who will seem more risky then? This immediate confidence in the US dollar that has come out of this European crisis could very quickly evaporate.

Alternatively, the underlying fiscal problems in Europe could fester – and the “rules” designed to limit moral hazard may turn out to be a complete paper tiger. In that case, the Europeans again have to make a fateful decision: Do they try to inflate out of the debt burdens of their weakest member countries; or do they instead try to manage selective default, keeping in mind that most Greek debt at that stage will be held by other eurozone governments.

## Restructuring The Eurozone

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The Baseline Scenario » 2010 » May 5/11/10 at 5:46 AM Simon Johnson

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By Simon Johnson

In today's *Financial Times*, Peter Boone and I have [an op-ed with proposals for reforming how the eurozone operates](#). The current arrangements have proved unstable – encouraging countries to run excessive budget deficits while also giving banks an incentive to both finance profligate governments and also fuel real estate bubbles.

Addressing these problems would require creating a “core” of countries that keep the euro, agree to much more

unification of fiscal policy, and put in a place a single strong bank regulator/supervisor. A move in this direction may not seem likely in the short-term, but the pressures are still building.

## Our Eurozone Call in October 2008 And Banking Reform Today

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The Baseline Scenario » 2010 » May 5/12/10 at 6:30 AM Simon Johnson

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*By Simon Johnson*

Eighteen months ago, on October 24, 2008, Peter Boone, James Kwak and I published an opinion piece in the Guardian (UK), "[Start by Saving the Eurozone](#)". We argued that the recession would put a great deal of pressure on the eurozone, because of flaws in its design.

Our proposals for addressing these issues, and preventing a broader global crisis, included:

"2. Create a European Stability Fund with at least €2tn of credit lines guaranteed by all Eurozone member nations and potentially other European countries with large financial systems such as Switzerland, Sweden and the UK. This fund should provide alternative financing to member countries in case market rates on their government debt become too high. This will prevent a self-fulfilling cycle of rising interest rates. The fund should be large enough to have credibility; countries could access the fund automatically, but should then adopt a 5-year program for ensuring financial stability, subject to peer review within the Eurozone."

It's unfortunate that policymakers – in Washington, Brussels, and pretty much everywhere else – ignored this suggestion until just now. But this tells you a great deal about what it takes to change any part of our economic system. It's only in the face of great crisis and the potential breakdown of financial markets that US and European authorities are willing to act.

The good news is that change happens. The bad news is that because leading governments are unwilling even to seriously discuss difficult economic scenarios ("too radical", "don't rock the boat", "powerful interests are opposed"), when they bring in new policies there is a great deal of improvisation and major mistakes are entirely possible. "Change only when we must" is a dangerous approach – see Hank Paulson in September 2008 (Lehman allowed to fail; AIG "saved" after a fashion; TARP proposed without any oversight, etc.)

And this is exactly why our seriously dysfunctional megabanks – in the US and in Europe – are not being "fixed". When the crisis breaks, people like Tim Geithner and Larry Summers say it would be too dangerous to even fire some boards of directors, let alone change CEOs in top banks. The anti-crisis improvisations focus in Europe – as they did under Mr Geithner's direction here – on "just save the big banks, as is."

But after you save the banks, they again become so politically powerful that they fight hard to block serious reform. They already turned back the effort to really limit their scale – the Brown-Kaufman amendment, defeated last week. And now they are striving to prevent effective restrictions on their scope – the Merkley-Levin amendment (supported in principle by Paul Volcker, the White House, and the president, coming up this week): [press release](#); [amendment text](#); [WSJ story](#).

If you don't fix the system now, you'll have another major crisis – and then you likely won't fix the system again.

## Supporting Swap Desk Spinoffs Just Got Easier

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The Baseline Scenario » 2010 » May 5/12/10 at 12:36 PM James Kwak

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*The following guest post was contributed by [Jennifer S. Taub](#), a Lecturer and Coordinator of the Business Law Program within the Isenberg School of Management at the University of Massachusetts, Amherst ([SSRN page here](#)). Previously, she was an Associate General Counsel for Fidelity Investments in Boston and Assistant Vice President for the Fidelity Fixed Income Funds.*

It's about time. Yesterday, by a vote of [96–0](#), the U.S. Senate passed a ground-breaking [amendment](#) to the financial reform bill. Introduced by Senator Bernie Sanders of Vermont, this amendment would require an audit of all emergency actions taken by the Federal Reserve since December 1, 2007. In addition, the amendment mandates that by December 1, 2010, the Fed reveal those who received \$2 trillion in zero or near zero interest Fed loans and what



those institutions did with the money.

This was the second recent “yes we can” show of bipartisanship. Last week, by a 96 -1 vote, the Senate approved an [amendment](#) introduced by Senator Barbara Boxer of California. The Senator described its purpose was to “protect taxpayers” through the creation of an “orderly process to liquidate failing financial firms and ensure that Wall Street pays to clean up its own messes.” Whether the amendment can live up to that promise is a good question. The answer depends less upon government intervention once a firm nears collapse and far more upon government prevention of the excesses that lead both to widespread failure and government support.

Moreover the impact on the American taxpayer of failing banks goes well beyond government spending. And as articulated [here](#) by Simon Johnson, cross-border complexities prevent the efficacy of a seemingly elegant US-based resolution mechanism. As the S.A.F.E.R. economists opined, “[It's Prevention. Stupid.](#)”

So, where am I headed with this line of thought? Here goes. These votes where 96 Senators, across notoriously rancorous party lines, support something, should send a signal. The way I interpret the signal is that these elected officials understand that voters want transparency and voters want to avoid bearing the costs of financiers' excesses. Thus, it is quite logical that the Senate should also overwhelmingly support preventing the very riskiest behaviors that required the bailouts. The Senate should support refusing to provide a Federal Reserve or FDIC or other lifeline to firms engaging in the high-profit, high risk behavior that enriches their executives, threatens the firms, creates systemic risk and cause widespread disaster.

At the top of that list are swaps. Swaps have been at the heart of major financial crises since the bankruptcy of Orange County. The Long-Term Capital Management meltdown, the failure of AIG and the Greek debt crisis, share this common component. Thus, it was a welcome moment in the reform process when Chairman Dodd included in the Senate bill, Senator Blanche Lincoln's proposal to require banks that receive Federal assistance to spin off swaps desks. A very useful [interview](#) of derivatives expert, Michael Greenberger on the Lincoln amendment can be found on Mike Konczal's rortybomb blog.

While some important voices, like White House economic adviser, former Fed Chair, Paul Volcker and FDIC Chair Sheila Bair have raised objections to aspects of the plan, the title of the recent Huffington Post [opinion piece](#) by economists Jane D'Arista and Gerald Epstein makes the counter-argument concisely, “Banks Must Be Barred from Dealing Derivatives: It's Not a Normal Part of the Business of Banking.” The authors explain:

“The controversial part of the amendment – section 716 – would ban Federal Reserve assistance through a credit facility or the discount window or loan or debt guarantees by the FDIC to any dealer in swap contracts. This would mean that banks that are insured by the FDIC – including the large banks that now dominate the market – would have to spin off their derivatives desks. Like the Volcker rule itself, the intent is to remove risky activities from the core banking functions that are essential to the economy and to ensure that those risky activities will not trigger the need for a bail out to prevent systemic collapse in the future as they did in the 2008 crisis.”

As a practical matter, this would affect the top 5 players who control about 90% of the swaps market, including Goldman, Morgan Stanley, Bank of America, Citigroup and JPMorgan.

Another swaps amendment that deserves overwhelming support was introduced by Senator Byron Dorgan of North Dakota. The Dorgan amendment would ban naked credit default swaps. A credit default swap is like a home insurance policy. With an insurance policy, the buyer pays the seller premiums. In exchange the seller agrees to cover the buyer's losses if there is some bad event occurs and damages the home covered under the policy. Similarly with a CDS, the buyer pays the seller a premium based upon a percentage of the underlying asset, typically on a quarterly basis. In exchange, the seller will compensate the buyer if there is a bad “credit event” such as a default involving the reference bond. With a naked CDS, the buyer is purely betting on the default of the bond or other reference credit.

If this were insurance, this practice would be prohibited, as laws prevent the purchase of coverage if you don't have an insurable interest. And, if it weren't for federal preemption of state gambling laws in 2000 with the passage of the Commodities Futures Modernization Act, states could refuse to enforce these contracts, or treat them as unlawful gambling. It's particularly ironic that conservative organizations are championing naked CDS when the existence of these instruments depends upon trampling on states' rights. The language of the CFMA made this clear when it stated that “it shall supersede and preempt the application of any State or local law that prohibits or regulates gaming or the operation of bucket shops.”

Additionally, given the harm caused, including let's remember the \$180 billion taxpayer-funded bailout to AIG (\$60 billion of which was paid through to bailout counterparties including \$12.9 billion to Goldman Sachs), it is stunning that we have not had a moratorium on these instruments. From that safe vantage point, we should then do a study where we can intelligently assess whether the yet-to-be-quantified benefits outweigh the tremendous harm.

And, here's a parting thought. The Senate may dazzle us with a 96–1 vote promising voters no more bailouts. That's terrific. Thanks. But, hello? We still own about 80% of AIG. And AIG has not yet paid back its loans from the Fed. So, let's get serious. Yes. I am glad that 96 senators agree that with regard to future messes, Wall Street should do its own clean up. But as for now, like the oil spilling into the Gulf, the mess continues and we have not been repaid. And, the mess, millions of jobs lost, double digit unemployment, massive cuts to state and local services, caused by the reckless practices on Wall Street remains. Thus, I welcome another bipartisan vote to spinoff the swap desks and ban the most dangerous swaps, since the financial sector has shown it cannot stop its toxic sludge from spilling into our economy and it has not completed the cleanup.

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## Senator Kaufman Was Right - Our Financial System Has Become Dangerous

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The Baseline Scenario » 2010 » May 5/13/10 at 5:54 AM Simon Johnson

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By Simon Johnson, co-author, "[13 Bankers: The Wall Street Takeover and The Next Financial Meltdown](#)"

**Update:** link to [Senator Kaufman's speech yesterday](#)

Senator Ted Kaufman (D, DE) is best known these days for arguing that, as part of comprehensive financial reform efforts, our biggest banks need to be made smaller. His advocacy on this issue helped build support around the country and forced a Senate floor vote on the Brown-Kaufman amendment, [which was defeated 33-61](#) last Thursday.

Senator Kaufman has also pushed strongly the idea that in recent years there was a pervasive "arc of fraud" within the mortgage-securitization-derivatives complex. This thesis also seems to be gaining traction – according to [the WSJ today](#), the criminal probe into this part of the financial sector continues to develop.

But the Senator's biggest home run has been on a different issue: [his warnings about the dangers](#) of high-speed trading, involving "dark pools" of money, appear to have been [completely vindicated – ironically enough, also last Thursday](#).

Think about it this way. The US stock trading system, long-established and widely thought to be robust, crashed on Thursday afternoon. Widely held stocks, traded with consistent liquidity, do not fall in value from \$40 to 1 cent and then bounce back again – even in emerging markets, let alone in the United States. It is true that complex systems crash, but given the infrastructure and back-up systems involved here, this is much closer to east coast air traffic control shutting down for 15 minutes than it is to your local cable company having a problem.

And here's the most remarkable point – after 6 full working days (and top people do sweat this kind of issue on the weekend), we are still no closer to really understanding what happened. To be sure, there are plenty of theories – and no shortage of proposals for avoiding a recurrence. But, despite the evident resources thrown at this problem, we do not know what went wrong.

As Senator Kaufman points out, the SEC does not even routinely collect the data it needs to understand the actions and impact of large traders.

The [Merkley-Levin amendment](#) would also likely be a step in the right direction, in terms of reducing the [socially dangerous casino nature of our financial markets](#). But it is far from enough.

The rationale for organizing our financial system as we do is that this leads to a reasonable allocation of capital across the economy. We can argue the merits of this proposition at various levels – but no one would suggest that the extreme volatility and breakdown of trading last week was anything other than completely dysfunctional.

The SEC is, without question, beginning to get its act together under Mary Shapiro. But there is also no doubt that it needs to lift its game to a much higher level, if regulation is even to catch up with how markets have developed over the past decade – just look at this [timeline of problem identification and policy response](#).

Senator Kaufman has flagged mortgage-related fraud, high-speed/dark-pool trading, and bank size as pressing issues to address. He was completely right on trading and, based on what we know so far, also right on fraud.

How long before he is completely proved right on the dangers posed by excessive bank size?

By Simon Johnson

Look forward. The holy grail of any serious financial market player must now be: Become Too Big To Fail. You can do it as a megabank – this part is obvious. But you can also do it as a hedge fund or some other lightly regulated pool of capital – this, after all, is the lesson of [Long Term Capital Management](#) that has never been addressed.

And quantitative trading, while in principle just one approach to investing or even only set of tools, greatly increases the complexity and opaqueness of markets – further allowing you to become big (in any future sense) relative to the political and economic system, and moving us closer to a more complete version of the stock market shut-down we saw on May 6.

For more on this, see my review of Michael Lewis's *The Big Short* and Scott Patterson's *The Quants* - now in The New Republic's [on-line book section](#).

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## Financial Safety and Fire Safety

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The Baseline Scenario » 2010 » May 5/15/10 at 10:29 AM James Kwak

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*This guest post was contributed by engineer27, a longtime reader of and frequent commenter on this blog. (I had exams this past week, which is why I haven't posted in a while.)*

This Thursday, the Senate added two [amendments](#) to the Financial Regulation in process that deal with Nationally Recognized Statistical Rating Agencies (NRSROs), which are blamed for being a factor in the financial crisis of 2008. The most widely [cited](#) problem with the NRSROs is the inherent conflict of interest which resides in the “issuer pays” model currently in use. However, even supporters of doing *something* are stymied when trying to envision a [workable solution](#). The two (perhaps contradictory) amendments each try to implement a proposed solution that runs into some of the critiques. The Franken amendment has rating agencies assigned to debt issues by a neutral arbiter; critics maintain that lack of competition may reduce the quality of analysis. The LeMieux amendment removes legal mandates to obtain a NRSRO rating and the preferential treatment those issues currently receive. However, it leaves out details about whose advice agencies and public trusts should seek out instead.

This is not such a difficult problem. We already have an example of a successful private rating agency, whose imprimatur is desired or in some cases required by law, that is paid for by fees on the seller, and has been operating since 1894: [Underwriters Laboratory](#). The UL publishes safety standards for almost 20,000 different types of products, many of which are adopted by other standard-setting organizations like ANSI (American National Standards Institute) and Canada's IRC (Institute for Research In Construction). Although generally not actually required by federal law, the sale of many types of products in the US would be difficult without UL listing. Also, many local jurisdictions responsible for building and fire codes mandate the use of UL approved products. In all cases, the manufacturer must submit samples and pay fees to UL in order to win approval.

The comparison to NRSROs is apt. In both cases, a third party sets standards based on theory, models, and best practices. In both cases, the issue is the assessment of risk by experts in that type of risk. In both cases, approval is desired by the market or required by local ordinance or rules. And in both cases, the seller pays the fees; so the third party might be led to relax their standards in order to capture some extra fee income. Yet in the case of fire safety the model has been functioning well for over 100 years, but in financial safety there has been a rash of fires as one rated product after another has blown up. Why?

There are a few key differences. [Until 2007](#), UL was completely non-profit, so as long as user fees covered their costs there was little incentive to chase extra revenue by relaxing standards. There is no real competition in the US market for UL (although Europe has its own standard-setting body that manages the ), so manufacturers have little leverage to push for easier standards. The LeMieux amendment could allow for the creation of a not-for-profit entity to take the place of NRSROs, while the Franken amendment would reduce competition, limiting it to delivering a better, more reliable rating rather than adjusting standards to capture fees.

Critics of the amendments, including those who support a buyer-pays model, need to address the question of why the UL model for risk assessment has worked well, and why it can't be applied to debt rating. Is the model broken? If so, I expect a rash of building fires any day. Is rating of financial safety fundamentally different than, say, electrical safety?

We should applaud the Senate for including important reform of NRSROs in the Financial Regulation package. If they are retained, collated and reconciled in Conference Committee, the door will be open to emulate a successful model that provides a comfortable revenue stream to fund improvements in service, and safety and soundness for all.

### 13 Bankers: Lehrer Newshour Edition – And Another Connection

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The Baseline Scenario » 2010 » May 5/16/10 at 9:20 AM Simon Johnson

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*By Simon Johnson*

On Thursday evening, the Lehrer Newshour ran [my discussion with Paul Solman](#) on American financial history and previous attempts to constrain the power of big banks - covering the main points in chapter 1 of [13 Bankers](#). On Paul's part of the Newshour website, we also talk about ["astroturf" organizations](#) that pretend to be reformist but are really just stalking horses for corporate interests opposed to reform.

We covered a lot of ground (and much of Manhattan) in 8 minutes, but we missed one potential irony. At the American Museum of Natural History, above the Teddy Roosevelt statue (and not readable, it turns out afterwards, in any of the shots) there was a huge banner celebrating an exhibit made possible in part by [David Koch \(a trustee](#) and major funder of [their dinosaur wing](#)).

Teddy Roosevelt would have loved the irony of appearing under a banner with Mr. Koch's name.

Among many other activities, Mr. Koch [chairs the trustees](#) of the Americans for Prosperity Foundation ([AFP Foundation](#)). The foundation is [related to but seaprate from Americans for Prosperity \(AFP\)](#) - an organization with a broad political agenda, including support for ["tea parties"](#) ([more on that here](#)).

The Foundation helps RightOnline – which [runs opposite NetRoots every year](#). It also supports ["Patients United Now"](#), which may or may not be regarded as a genuine grassroots organization. – their website does disclose that this is [a "project" for the AFP Foundation](#).

But there are also alleged instances where [crowd appearances have been funded](#) in a nondisclosed manner by AFP and its allies.

AFP's official list of issues [does not include financial sector reform](#) – either for or against – and this is also not in the Foundation's [highlighted research](#). However, at least according to some researchers, AFP is [very much involved in financial sector lobbying](#) - along with payday lenders and other special interests (for more detail, see [the online version](#)). Given the high level of disclosure and clear publicity around AFP's other activities, the alleged clandestine nature of the activities here is interesting.

Rachel Maddow previously established that [DCI helps the phony "Stop Too Big To Fail" \(STBTF\) group](#) - a point confirmed to me by the main STBTF organizer himself (more on [DCI Group](#)). Whether or not there is a link here to AFP and related structures remains to be seen.

These are issues and personalities that Teddy Roosevelt would have relished confronting. Unfortunately, it's not yet clear if any modern politicians feel similarly inclined.

### The Cost of "Multitasking"

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The Baseline Scenario » 2010 » May 5/16/10 at 1:56 PM James Kwak

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*By James Kwak*

"I've given lectures on incivility around the globe. When I ask audiences whether anyone considers sending e-mail or texts during meetings uncivil, almost everyone raises their hand.

"Then, when I ask whether anyone in the audience sends texts or e-mail during meetings, about two-thirds acknowledge the habit. (Presumably, there are still more who don't want to admit it.)"

That's [Christine Pearson](#), from her article in *The New York Times*.

There are at least two things going on here. One, which Pearson discusses, is the myth of multitasking. Research shows that when you try to do two things at once, you only do one of them—or you do both of them, but your total productivity goes down. (You would get everything done in less time if you did things one at a time.) Yet most people stubbornly refuse to acknowledge this about themselves.

But what about the situation where the meeting you're in really is useless: you're not getting any value out of it, and you have nothing to add. Then isn't it OK to check your email on your iPhone?

Maybe, but you're still overlooking the cost of being rude to the people around you. That can affect you directly, via their negative opinion of you. Or you could just be contributing to making the world a more rude place.

And you're probably making yourself less happy, because one component of happiness is mindfulness—being aware of the world around you. Another component of happiness is interacting with people—and no, email doesn't count.

I don't claim to be perfect. At Yale Law School, most professors allow laptops in class, and the vast majority of students use them. Not surprisingly, at any given moment, many of them are using them for something other than taking notes or looking at the class reading. I believe I have learned more in classes where professors ban laptops. I even prefer classes where professors ban laptops. Yet, when given the opportunity, I use a laptop—and I sometimes use it for things other than class. How's that for irrationality?

## Thinking About Financial Reform

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The Baseline Scenario » 2010 » May 5/17/10 at 9:31 AM Simon Johnson

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By Simon Johnson, co-author of [13 Bankers](#)

There are three contending narratives regarding the financial reform legislation that this week approaches its final hurdles in the US Senate.

The first narrative is “the reforms would make things worse.” This view, advanced recently by some Republican leadership, seems to have receded in recent weeks – at least with regard to systemic risk – particularly after Senator Ted Kaufman [dealt with it rather brutally](#) on the Senate floor. For the most part, this line has sunk down to the level of [sneaky astroturf campaigns](#).

There is still a rear-guard action by special interests against consumer protection on financial products, but here the administration started out with a sensible vision and – with strong support along the way from the likes of Elizabeth Warren – reasonable safeguards will eventually emerge. The biggest remaining item is probably the [Whitehouse Interstate Lending Amendment](#), which would definitely help – call your senator, but only if you don't like being gouged by credit card companies.

The second narrative is “[Obama administration as heroes](#).” Against the odds, in this view, the administration has prevailed in the teeth of tough opposition.

The problem with this story is that – even in the official version – the only people who have been trying hard to strengthen reform, beyond the initial proposals, over the past year are those relatively outside the main White House-Treasury team: Gary Gensler and Paul Volcker.

Gensler has won some battles – although the final outcomes on derivatives are not yet clear. And, in any case, the industry won its main battle some months ago when [the “end user” exemption](#) prevailed. The big broker-dealers in over-the-counter (OTC) derivatives mobilized their clients to lobby the Senate Banking Committee – it was all handled in the most professional and (socially) damaging way possible. This loophole seems relatively small now (10-15 percent of all OTC derivatives), but no doubt it will expand greatly over time. Watch this space closely for the next crisis.

Volcker's ideas are still in play – in fact, [the big fight this week](#) will likely be on the Merkley-Levin amendment, which would greatly strengthen the idea that the biggest banks should stop already with their “proprietary trading”, which leads them into [great and completely botched risks](#), as well as repeated conflicts of interest with their clients.

The big banks have no good arguments on their side – they are reduced to asserting that being able to take risks in this manner actually makes the system more stable, a point directly contradicted by their experience in the run up to September 2008. It was the bank's own holdings of “toxic assets”, you may recall, that were the focus of rescue

attempts organized by both Hank Paulson and Tim Geithner. Holdings at this scale were not acquired in the day-to-day mundane business of bringing buyers and sellers together. Instead, very smart people at the big banks thought this was a good investment – a point on which [they proved devastatingly wrong](#).

The administration says it favors Merkley-Levin, but let's see how hard they fight for it. Personally, I rather expect their support will be lukewarm and this will ultimately not tip the balance. I'd be happy to be proved wrong.

More broadly, of course, all of these reforms add up to little more than “baby steps”. The big mistake was made long ago, when the administration decided not to push the megabanks when they were politically weak (the argument of [13 Bankers](#)). This was only compounded and confirmed when Treasury and the White House [came out against the Brown-Kaufman amendment](#).

As a result, the financial system will remain largely the same as it was before September 2008 – perhaps the megabanks will be slightly constrained in their activities, most likely not (at least for Goldman, JP Morgan Chase, and Morgan Stanley.)

As we argued in our [start-of-the-year piece on Bloomberg](#), all of this sets us up for another boom-bust cycle, this time centered around emerging markets. Savings will be recycled out of emerging markets through “too big to fail” banks and similar institutions in the US and some parts of Western Europe – generating debt-based capital flows back into other parts of those same emerging markets.

“China can only go up”, “Russia is back”, and “Brazil and India are now different” are the siren calls. And of course, to some extent there is truth in this rhetoric – but the expectations are already becoming exuberant.

All great bubbles begin with a truly convincing shift in fundamentals. And many of them are all kept going by reckless lending on the part of Citigroup and its competitors – remember emerging markets in the 1970s and 1990s, US commercial real estate in the 1980s, and US residential real estate in the last decade.

## Agreeing on the Problem

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The Baseline Scenario » 2010 » May 5/17/10 at 10:04 AM James Kwak

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*By James Kwak*

Over the past month, Simon and I have become very closely associated with the Brown-Kaufman amendment to break up big banks, and that's an association I welcome, especially given the last chapter of [13 Bankers](#). The fact that the amendment came from basically nowhere and got thirty-three votes in the Senate is, to me, an encouraging sign. But while this solution looks like it is unlikely to pass in this session of Congress — and there is debate about whether it is the right solution to begin with — the more encouraging sign is the amount of agreement on the problem to be solved: a financial system that is too big, too concentrated, and too powerful.

I wrote a guest post for the [Harvard Law School Forum on Corporate Governance and Financial Regulation](#), a group blog, on this broader issue and some of the other solutions that have been floated. As we've said many times, as long as debate moves in this direction, that's progress.

## ABA Argues That Black Is White and Must Stay That Way

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The Baseline Scenario » 2010 » May 5/17/10 at 11:49 AM James Kwak

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*By James Kwak*

I wasn't sure if I was going to write about the Whitehouse Amendment, which would allow states to regulate the interest rates charged to their residents. According to a 1978 Supreme Court decision, financial institutions are governed by the law of the state that *they* reside in, not the laws of the states they do business in; the result was the current situation, where the big credit card issuers are based in South Dakota, because Citibank basically wrote South Dakota's consumer credit laws. In its essence, the [amendment says this](#): “The interest applicable to any consumer credit transaction [not a mortgage], including any fees, points, or time-price differential associated with such a transaction, may not exceed the maximum permitted by any law of the State in which the consumer resides.”

Obviously I'm in favor of it, as the current system just allows the worst kind of regulatory arbitrage. (Note that administration officials like to oppose strict legislative measures, like a hard leverage cap, on the grounds that these things need to be negotiated internationally so that banks won't just set up shop in the most lightly-regulated jurisdiction — yet that's exactly what happens with credit cards.) But I wasn't sure what there was to add, since [Mike Konczal](#) and [Bob Lawless](#) have already weighed in.

Then I read the [ABA's argument](#) against the amendment, that gave me all the motivation I needed.

Here is one of its arguments, broken up into four paragraphs:

“The state rate cap may be based on an all-inclusive APR that is different from the Truth in Lending Act (Regulation Z) definition of APR. For example, the interest rate calculation under the bill could include application fees, late payment fees, and annual or periodic fees. This means the rate calculated under a state rate cap could be higher than the Regulation Z APR, making it more likely a lender will reach the state rate cap, particularly for small dollar loans with short terms.”

Um . . . that's the point. Right now banks are allowed to pretend that application fees, late payment fees, annual fees, and periodic fees are *not* part of the cost of credit. That's a *bad* thing. And if the federal agencies aren't going to fix it, then states should be allowed to. “Making it more likely a lender will reach the state cap” is a good thing if what makes it more likely is the elimination of a misleading loophole.

“Determining the state rate cap for open-end credit and overdrafts would be particularly problematic, as it would have to be determined retroactively (the ‘historic’ APR) in order to take into account fees such as periodic fees and late payment fees. Banks would have to either significantly limit or eliminate all such fees so that the APR would be under the state rate cap, or simply not offer those products.”

Again, that's a feature, not a bug. If the only way banks can offer a product is by hiding its true cost outside the APR, then the product shouldn't exist. State legislatures should have the power to determine what the maximum cost of credit should be. Here the ABA's complaint is that banks won't be able to evade that limit through dodgy accounting.

“Overdrafts are ‘credit’ according to bank regulators, but currently the fees are not considered ‘finance charges,’ and therefore exempt from Regulation Z. State laws would be permitted to limit the ‘interest’ on overdrafts by treating them as open-end loans subject to a retroactive ‘effective’ or ‘historic’ APR calculation and limiting the amount that may be charged.”

If overdrafts are credit, then the cost of credit should be disclosed and regulated, one way or another. Reading the first sentence above, the only reasonable inference to be drawn is that the fees should not be exempt from Regulation Z.

“Affordable small dollar loans such as those intended as alternatives to payday loans, (such as the 36 percent loans suggested under FDIC's affordable loan pilot) may not be permitted under state laws. By definition, loans that are small dollar amounts, have fixed costs that are part of the finance charges and reflected in the APR, and have short terms will have higher APRs likely to exceed any state interest rate cap.”

I like this positioning of “affordable small dollar loans such as those intended as alternatives to payday loans.” If those things would be banned by state law, *so would payday loans*. The Truth in Lending Act already applies to non-bank lenders, even if the Greenspan Federal Reserve neglected to enforce it.

The ABA's argument boils down to this: Right now, federal regulations allow us to hide the true cost of credit. State laws might not let us hide it anymore. We can't let that happen.

The other main argument that I see against this amendment is that it increases the cost of regulatory compliance for banks. Again, that's a good thing, relative to where we are now. Sure, the optimal outcome would be a single federal regulatory system that was good and well enforced. But we've just lived through an episode that has proven that you can't count on the federal regulatory agencies to do their job.

Besides, the costs will be lower than industry advocates claim. First, the vast majority of banks only operate in one state, or at most a couple (since the vast majority of banks are very small). Second, the insurance industry has dealt with this issue since forever, and while the insurance industry has its problems, it generally works. (And many of those insurance regulations are *process* regulations, such as the amount of time you have to respond to a notification, which are considerably harder to comply with than rate regulations.) Third, the programming to ensure that you aren't violating a state interest rate regulation based on the customer's state is trivial (although, given most large enterprise IT environments, it could take months), especially compared to the programming the banks do to decide which mailing to send you.



Of course I think there is a role for the federal government when it comes to regulation. Imagine what the country would be like if we didn't have the federal government to set a minimum floor when it comes to civil rights, or clean water, or guns. (Um, strike that last example.) But just as in the civil rights arena, I think Washington should set a minimum floor of constraints (for example, no employment discrimination on the basis of race or gender) that states can go beyond if they so choose (no discrimination on the basis of sexual orientation).

As always, it will be interesting to see if the nominally pro-states' rights Republican Party will go along with an amendment that is all about states' rights.

**Update:** If there was any doubt, that's the American Bankers Association, not the American Bar Association.

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## Senator Ted Kaufman: Financial Reform Against The Odds

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The Baseline Scenario » 2010 » May 5/18/10 at 5:45 AM Simon Johnson

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By Simon Johnson, an excerpt from my [latest column on Project Syndicate](#)

America's financial sector has shown renewed strength in recent months – political strength, that is – by undermining most of the sensible proposals for banking reform that remain on the table. If we are still making any progress at all, it is because of the noble efforts of a small number of United States senators.

Most notable has been the work of Senator Ted Kaufman, a Democrat from Delaware (yes, a pro-business state), who has pressed tirelessly to fix the most egregious problems in the US financial sector. Kaufman understands that successful reform requires three ingredients: arguments that persuade, the ability to bring colleagues along, and a good deal of luck in the form of events that highlight problems at just the right time. On two fronts, Kaufman has – against long odds – actually managed to make substantial steps.

[The rest of this article is available \(free\) on Project Syndicate.](#)

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## Sam Brownback's Staff Are Amateurs

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The Baseline Scenario » 2010 » May 5/18/10 at 10:20 AM James Kwak

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By James Kwak

Senator Sam Brownback has been pushing an amendment in the Senate that would exempt auto dealers from regulation by the Consumer Financial Protection Agency. The auto dealer exemption has gotten a lot of press. The House version of the exemption was the focal point of a [Huffington Post story](#) back in December on how the House Financial Services Committee was loaded with moderate Democrats who are weak on financial reform. (That amendment was introduced by John Campbell, a former auto dealer who is no longer an auto dealer but who owns real estate that he rents to auto dealers.)

The argument for the exemption is that regulating auto dealers will — you guessed it — reduce access to credit.\* The arguments against are: (a) auto loans are a major source of financing for consumers, along with mortgages and credit cards, so people need to be protected; (b) auto loans provide even more opportunities for ripping off customers than most bank loans, because of the auto dealer's privileged market position and its ability to shift money back and forth between the sale price and the loan fees; and (c) if you open up this loophole, you will have regulatory arbitrage.

Anyway, to support his amendment, this is what Brownback wrote in a letter to the under secretary of defense.

“CNN Money on May 13 reported that ‘Raj Date, executive director of the Cambridge Winter Center for Financial Institutions Policy, agreed that the additional [CFPA] regulation might cause some dealers to stop arranging loans.’”

This is the full passage from the [CNN Money story](#) that Brownback cited.

“Raj Date, executive director of the Cambridge Winter Center for Financial Institutions Policy, agreed that the additional regulation might cause some dealers to stop arranging loans.

“There will be some dealers who say ‘If I have to play by an honest set rules, then I can’t be in this business anymore,’” Date said. ‘I’m not going to shed any tears for these dealers.’”

Date’s point is that insofar as credit will be less available, it will be less available because dealers won’t be able to screw customers anymore and with stop offering financing. That’s a good thing.

Now, Brownback certainly didn’t write that letter; some staffer of his did. That staffer knew that he was citing Date to support a point that is the opposite of what Date was actually saying, but did it anyway. That’s the kind of thing you do in a college paper, not something you should be doing in Congress.

Of course, it’s possible to make an honest mistake, like if you only read the abstract of a paper and not the whole thing (though it’s still a mistake). But in this case, the staffer only had to read *one more sentence*. That’s not an honest mistake.

\* There is another “argument” for the exception, which is that auto loans didn’t cause the financial crisis. But this is not really an argument, since there is no rule that says that a bill can only be passed if it directly responds to a cause of a crisis that occurred within the past twenty-four months.

## Constructive Populism

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The Baseline Scenario » 2010 » May 5/18/10 at 2:26 PM James Kwak

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*By James Kwak*

I don’t expect to get a holiday card from Tim Geithner this winter. Nor do I expect one from Larry Summers. Or even Michael Barr, despite everything I’ve written in favor of consumer protection. (I probably will get one from Barack Obama, since I donated money to his campaign.) But they might want to consider putting me on their lists.

“Populist” has mainly been used as a smear over the past year and a half, to connote irresponsible pandering to . . . well, to the people, actually. Simon and I have been written off by many people as populists, as if that alone were enough to settle the argument. But if and when financial reform does finally get passed by both houses of Congress, the administration will owe a major debt to the recent resurgence of anti-Wall Street sentiment, which can only be called populist.

[Politico](#) ran a story on Monday about how, contrary to everyone’s expectations (including mine), the financial reform bill is getting *stronger* as the days pass, not weaker. Goldman Sachs has a public approval rating of 4 percent. There is even chatter among a few Republican Senators that they should let the bill pass now, because as time passes it will get worse (from their perspective). The original Republican strategy — denounce the bill as a sell-out to Wall Street — has completely failed.

Yes, the Brown-Kaufman amendment failed — although thirty-three votes were a couple dozen more than I would have bet on just a few weeks before. The [New York Times](#) earlier reported that the big banks’ lobbyists were so focused on defeating Blanche Lincoln’s proposal to split off derivatives dealers (into independent subsidiaries of bank holding companies, it must be pointed out) that they had given up on virtually every other issue. Now the bill even regulates debit card fees.

This situation is not entirely welcome to the administration, which is in the somewhat uncomfortable position of having to fight off some of the more liberal amendments, such as Brown-Kaufman or “audit the Fed” (which they succeeded in watering down somewhat). But on balance, they’d much rather be in that position than where they were with health care, begging moderate Democrats to stay on board in the face of increasingly negative poll numbers.

The background to this political story is the return of what can only be called populist, anti-Wall Street sentiment. It was fueled a little by the [SEC’s lawsuit against Goldman](#), a little by media stories such as the [This American Life](#) episode on Magnetar, and probably a lot by the increasingly stark contrast between a dismal job outlook and the return to profits and bonuses on Wall Street. I think our book helped a little, too, although we were admittedly more a beneficiary than a cause of this trend; there were a lot of people in Washington who read it, and maybe it made a few of them a little bit more nervous about being seen as part of the “Wall Street takeover.”

At the end of the day, I think populism can be a constructive political force. We will still end up with a relatively moderate piece of legislation (and maybe some people are hoping that the anti-Wall Street wave will subside before conference committee); but without it, we might have ended up with nothing.

## Finally, The Republicans Come Out To Fight. Where Is The President?

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The Baseline Scenario » 2010 » May 5/19/10 at 8:19 AM Simon Johnson

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The Senate Republicans [are refusing to allow a vote on the Merkley-Levin amendment](#), which would put [a meaningful version of the Volcker Rule](#) into law (splitting off proprietary trading from major banks).

After weeks of dancing around, the Democrats finally have a signature issue on which to fight. Senator Carl Levin frames it exactly right: “It’s a sad day when the power of Wall Street can overwhelm the power of the American people in the US Senate.”

This is the opportunity that White House claims it has long sought – to have an intense fight on a financial reform issue that everyone can understand. Paul Volcker [made his determination long ago](#): the big banks are too big and must, in this fashion, be broken up. Senators Merkley and Levin negotiated the precise language of their amendment in good faith. The Republicans have made their answer clear: No way.

Time for President Obama to make the call.

Only the president can break through the daily logjam of information. Only the president can define the issues in the simple, powerful and convincing terms that people can grasp. Only the president can insist – this is a matter of urgent national priority.

The economic analysis (Volcker), political back-story (Brown-Kaufman [and all that involved](#)), and just the [right rhetoric are already in place](#):

“We got into this financial crisis because Wall Street set the rules to benefit itself, and now with an assist from Senate Republicans, they’re doing it again,” said Merkley. “Obviously the lobbyists are afraid they’ll lose this vote, and in typical Wall Street fashion their solution, with help from Senate Republicans, is to rig the result. Main Street is being shut out of this debate. It is time to stop letting Wall Street call the shots – let this amendment have a vote.”

“The long arm of Wall Street reached directly into the Senate chamber today,” Levin said. “By blocking us from even debating this amendment, the Republican leadership is carrying Wall Street’s water and standing in the way of real reform.”

This is a defining issue for the president. Either he takes up the Volcker Rule – proposed by his administration, to great fanfare (and [some skepticism](#)) in January. Or he rolls over – admitting that Wall Street has won.

We know where Goldman Sachs and its fellow travellers stand on this issue – adamantly and publicly opposed. And we pointed out here in February which way [the Republicans were likely to go](#).

“But if you don’t have the votes in the Senate, what can you do?” This one is easy. You stop the clock and put everything else on hold. The president calls the American people to order and asks them to take a long hard look at the issues and the corporate interests at stake.

And then you start to pound away. Day in and day out, the president and other leading members of his administration need to come out swinging with relentless pursuit of substance on TV talk shows and prime time speeches – demanding an up-or-down vote on Merkley-Levin.

Admittedly, this may be awkward for leading officials, who have been rather accommodative to financial interests over the past 15 months or so. That’s unfortunate (for them), but now entirely water under the bridge. All is forgiven to the policymaker who finally gets it and changes course in the right direction.

Don’t move on. Pick up the baseball bat that Paul Volcker has given you. Either that or go down to the most embarrassing, humiliating, and memorable defeat in the history of Wall Street-Washington confrontations. It’s the president’s call.

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## In Defense Of Europe's Grand Bargain

The Baseline Scenario » 2010 » May 5/19/10 at 9:24 AM Simon Johnson

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*This guest post is by Jacob Funk Kirkegaard, a [research fellow at the Peterson Institute for International Economics](#). He is more positive than the current consensus on recent economic and political developments in the eurozone.*

The frantic spectacle of European leaders struggling to avert a financial crisis caused by Greece has seemed unsettling and at times amateurish. It is certainly easy to point fingers at policy makers patching solutions together solutions that immediately unravel under pressure from the markets, and to do so again and again over the last several weeks.

But if you look less at the sausage-making process and more at the final result, you have to be impressed. There are of course many painful steps that still need to be undertaken by all sides – the Greeks, the weaker European economies, the European banks and the European governments. But the derision of some commentators and the uneasiness of the markets seems overstated.

Recall the disdain, for example, when the TARP was introduced in late 2008 or the bank stress-tests were carried out last year. Today most would argue that they ultimately played a large and constructive role in containing the immediate crisis contagion. In time, Europe's response to the Greek crisis will be viewed in a similar positive light.

Though numerous and poorly timed, Europe's policy reversals during this crisis have at least been in the right direction. European leaders went from a "small number with no IMF involvement" to the required "BIG number with 100% International Monetary Fund (IMF) conditionality" for all the money involved. It is difficult to imagine a stronger endorsement of the much-maligned multilateral organizations than the willingness of large euro-zone governments to commit hundreds of billions of taxpayer's money exclusively under conditions imposed by the IMF.

Second, and more important, European leaders have produced a constructive political "grand bargain" between member states and the European Central Bank (ECB) concerning the future of European monetary union.

For its part, the ECB agreed to move beyond its minimalist obsession with price stability, a legacy of the Bundesbank mentality and in defiance of Germans on the central bank's Council. It has effectively agreed to become a credible "lender of last resort" and crisis manager for the entire euro-zone by granting its own Governing Board the ability to buy essentially whatever asset – public or private – they want through their new "Securities Market Program." With the new powers it essentially granted itself, the ECB now has the ability to counter most of the contagion risk from a future Greek default.

The crucial and politically more important question, however, is what the EU member states are now prepared to contribute to this "grand bargain." It would seem logical that the next step involve a European fiscal as well as monetary union permitting massive intra-European fiscal transfers from the richest to the neediest countries. But that prospect does not exactly lie around the corner. No revision of the Lisbon Treaty (which would be required for this scenario) institutionalizing regular budget transfers will be passed by the EU or the key euro-zone members any time soon.

Instead, member states have agreed to put on a "fiscal straight jacket" and accept "legislated deflation," following the path of Latvia, Ireland, Greece (too late of course), Spain, Portugal and now Italy. In these cases, governments have cut public wages (wages in Europe have proved far less sticky in this crisis than economic theory would predict) and taken a host of other fiscal austerity measures. The negative short-term effects on European growth prospects are obvious.

The volte face of the leftwing Spanish government after the "grand bargain" was announced to risk political suicide by cutting public wages and freezing pensions means that the resolve of euro-zone governments to act in the face of crisis must be taken seriously. Europe really does seem prepared to embark on "coordinated fiscal austerity" and move back to Maastricht Treaty basics.

Will this new political commitment to a "new Stability and Growth Pact" (SGP) be more credible than it was in 1997 (when the 60% debt stock criteria was abandoned) or in 2004 (when the big euro-zone countries undermined the 3% deficit criteria)? It is early days, but the signs from Madrid and elsewhere are good. A likely Greek default will illustrate the devastating result of non-compliance, and the political cost of running unsustainable fiscal policies. Seeing what will happen to fiscally wayward countries is certain to shock European electorates and alter what kind of fiscal policies are politically sustainable in Europe.

One lesson of this crisis is that the days of a phony euro-zone government bond yield convergence are gone for good. Financial markets now happily and rapidly apply very significant default premia on irresponsible euro-zone countries. The "new SGP" will not have to be pressed by politically reticent European governments. Instead it will be enforced real time by financial markets. The chimera of "political peer pressure" is gone, replaced by the iron law of the marketplace. This is a positive step.

Without a unified fiscal or political authority, the European house does remain “half-built.” But now the world gets to find out whether the European project is based on a fundamentally flawed design or whether it works when member countries actually stick to the rules.

Finally, the European actions, while painful, have accomplished what is necessary to prevent a contagion from a medium-term Greek default – for example, in the form of a debt restructuring next year. In that sense, it – could well serve as an important stress test for the “grand bargain” negotiated this month. Any new SGP cannot hope to function in the long-term without a willingness by the EU to let insolvent countries go, while protecting the solvent members from the associated contagion. A Greek default might therefore be politically necessary to mark the limits of moral hazard for the rest of Europe.

## Fire Up Twitter

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The Baseline Scenario » 2010 » May 5/19/10 at 10:02 AM Simon Johnson

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The White House has over [1.75 million followers on Twitter](#).

The latest presidential tweet is a bit stale (17 hours ago), but right on target.

“Obama to Senate GOP blocking increase in oil company liability: “stop playing special interest politics”  
<http://bit.ly/d65ifY>”

The White House needs to send out the exact same message, but replacing “increase in oil company liability” with “financial reform”, and then linking to the Merkley-Levin amendment and the [imminent failure of the Volcker Rule and meaningful financial reform](#).

How hard can that be?

**Update (12:40pm):** at about 10:30am, the president’s staff put out this tweet (@BarackObama; i.e., <http://twitter.com/BarackObama>, with nearly 4 million followers):

“It’s time for Wall St. reform that gives greater security to folks on Main Street. Call your Republican Senators today: <http://i.mp/cwhtq7>”

Good tweet – but the president should call explicitly for Merkley-Levin to pass; this is his own Volcker Rule, after all. Here’s Senator Jeff Merkley, to the point: <http://twitter.com/senjeffmerkley>

## The Middle Ground On Financial Reform

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The Baseline Scenario » 2010 » May 5/20/10 at 6:04 AM Simon Johnson

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*By Simon Johnson*

[In Politico this morning](#), I question whether the president should really be seen as “centrist” or “moderate” with regard to financial reform. His staff goes to great lengths to make this claim, including both the specific quotes and general tone [in the Financial Times on Tuesday](#) (May 18, p.7).

Treasury Secretary Tim Geithner:

“I would say [the president] is fundamentally at the centre and pro-market. But he recognizes the market cannot solve all problems.”

Larry Summers:

“Sometimes the most courageous thing to do is not to take the largest and most sweeping course of action.”

But if this is the correct way to frame the president’s position, how can we explain the fact that it is moderates – not left-wing radicals – who are pushing (against the White House, among others) for stronger reform both within the

administration and in Congress? [I suggest another interpretation](#): On financial reform, the president does not hold the middle ground.

## The Very Bad Luck of The Irish

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The Baseline Scenario » 2010 » May 5/20/10 at 6:15 AM Simon Johnson

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*By Peter Boone and Simon Johnson*

With the European Central Bank announcing that it has bought more than \$20 billion of mostly high-risk euro zone government debt in one week, its new strategy is crystal clear: We will take the risk from bank balance sheets and give it to the central bank, and we expect Portugal-Ireland-Italy-Greece-Spain to cut fiscal spending sharply and pull themselves out of this mess through austerity.

But the bank's head, Jean-Claude Trichet, faces a potential major issue: the task assigned to the profligate nations could be impossible. Some of these nations may be stuck in a downward debt spiral that makes greater economic decline ever more likely.

Prime Minister George Papandreou said this week that Greece needs to see strong investment in order for the austerity program to work. While the government cuts fiscal spending, he said, it needs new private business to employ the dismissed workers so that they are productive, can pay taxes and do not need unemployment benefits.

The problems are strikingly reminiscent of Latin America in the 1980s. Those nations borrowed too heavily in the 1970s (also, by the way, from big international banks) and then — in the face of tougher macroeconomic conditions in the United States — lost access to capital markets. For 10 years they were stuck with debt overhangs, just like the weak euro zone countries, which made it virtually impossible to grow.

Debt overhangs hurt growth for many reasons: business is nervous that taxes will go up in the near future, the cost of credit is high throughout society, and social turmoil looms because continued austere policies are needed to reduce the debt. Some Latin America countries lingered in limbo for a decade or more.

Mr. Trichet and Mr. Papandreou can look more closely at home to see what might soon be going wrong. Ireland was one of the first nations to introduce tough fiscal austerity in this cycle — in spring 2009 the government slashed public-sector spending and raised taxes. Despite the cuts, the European Commission forecasts that Ireland will have one of the highest budget deficits in the world at 11.7 percent of gross domestic product in 2010. The problem is clear: when you cut spending you also lose tax revenues from people who earned incomes from that money. Further, the newly unemployed seek benefits, so Ireland's spending cuts in one category are partly offset by more spending in another. Without growth, the budget deficit still looms large.

Ireland's problems are, sadly, far deeper than the need for simple fiscal austerity. The Celtic tiger's impressive reported growth over the past decades was in part based on its aggressive attempts to help major corporations in the United States reduce their tax bills. The Irish government set corporate taxes at just 12.5 percent of profits, thus attracting all sorts of businesses — from computer services such as Google and Yahoo, to drug companies such as Forest Labs — that set up corporate bases and washed profits through Ireland to keep them out of the hands of the Internal Revenue Service.

The remarkable success of this tax haven means that roughly 20 percent of Irish gross domestic product (G.D.P.) is actually "profit transfers" that raise little tax for Ireland and are owned by foreign companies. Since most of these profits are subject to the tax code, they are accounted for in Ireland where they are lightly taxed; they should not be counted as part of Ireland's potential tax base. A more robust cross-country comparison would be to examine Ireland's financial condition ignoring these transfers. This is easy to do: a nation's gross national product excludes the profits of foreign residents. For most nations, gross national product and G.D.P. are near-identical, but in Ireland they are not.

When we adjust Ireland's figures accordingly, the situation is dire. The budget deficit was about 17.9 percent of G.N.P. in 2009, and based on European Commission projections (and assuming the G.N.P.-G.D.P. gap remains the same) it will be roughly 14.6 percent in 2010 and 15.1 percent in 2011, while the debt-to-G.N.P. ratio at the end of this year is expected — by our calculation — to be 97 percent, and 109 percent at the end of 2011. These numbers make Ireland look similarly troubled to Greece, with a much higher budget deficit but lower levels of public debt.

Ireland's politicians, rather than facing up to their problems, are making things ever worse. Simply put, the Irish miracle was a mirage driven by clever use of tax-haven rules and a huge credit boom that permitted real estate prices and

construction to grow quickly before now declining ever more rapidly. The [biggest banks grew to have assets twice the size of official G.D.P.](#) when they essentially failed in 2008. The government has now made a fateful choice: rather than make creditors pay some part of the losses, it is taking the bank debt onto the national balance sheet, effectively ballooning its already large sovereign debt. Irish taxpayers are set to be left with the risk of very large payments to make on someone else's real estate deals gone bad.

There is no simple escape, but if the government hopes to avoid a sovereign default, the one overriding priority should be to stop bailing out the banks. Instead, the government should wind down existing banks in a "bad bank," while moving their deposit base and profitable businesses into new, well-capitalized banks that can function without a taxpayer burden. This will be messy, but it is far better than a sovereign default.

Second, the Irish must take the tough fiscal steps that will be required under any circumstances. The International Monetary Fund and the European Union have made clear that funding is available to Ireland — so the government should use this to bridge the tough journey of fiscal cuts ahead.

Finally, the Irish need to consider seriously whether being in the euro zone is worth the cost. The adjustment to this awful situation would be far easier outside the euro zone — even though leaving the zone might have adverse repercussions for other nations. Once again, a comprehensive program with European Union/I.M.F. support might make this the least worse option.

Given the depths of Ireland's problems, it is no wonder the markets are looking with skepticism at the announced eurozone-wide bailout package provided by the E.U. and the I.M.F. Policy makers are still not dealing with the core problems of each nation in the euro zone. With the debt hangovers remaining, who will want to invest in Europe's periphery, and so how can Greece, let alone Ireland, grow? One thing we can be sure of: Europe's political leaders are doomed to be spending much more time at emergency meetings in Brussels over the coming months and years.

*An edited version of this post appeared this morning on the [NYT's Economix](#) and this material is used here with permission. If you wish to reproduce the entire article, please contact the New York Times.*

## Reforming Credit Rating Agencies

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The Baseline Scenario » 2010 » May 5/20/10 at 11:30 AM James Kwak

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*This guest post was contributed by Gary Witt, an assistant professor in statistics and finance at the Fox Business School at Temple University. He was previously an analyst and then a managing director at Moody's Investors Service rating CDOs from September 2000 until September 2005. Witt also caught one error in 13 Bankers, which I explain [here](#).*

Many readers will think that the last person whose opinion should be consulted on the issue of rating agency reform is a former rating agency employee. Maybe they're right, but I did learn one thing from rating hundreds of complex securities. Contrary to what some may think, there are no easy solutions here. Unintended consequences are guaranteed. So here's my humble take on the current CRA reform proposals.

### What should be the goal of rating agency reform?

In 2007, as S&P and Moody's were trying to decide how to rerate the entire structured finance debt market, I asked a shrewd fund manager what advice he would give to the management of a rating agency. He said they have to get the ratings right. No matter how hard it is, they have to focus on getting the ratings right.

There is an alternative school of thought. Instead of improving ratings, the reform agenda should be to eliminate their use. Since the rating agencies are hopelessly stupid or corrupt or both, just say no. End the market's addiction to credit ratings by eliminating the SEC designation Nationally Recognized Statistical Rating Organization (NRSRO). Go cold turkey and end the practice of using ratings to assess credit risk by governmental or regulatory entities.

These two competing goals, improve credit ratings and eliminate credit ratings, can be viewed from a larger perspective, a Minsky mindset. If stability breeds instability, then trust breeds disappointment; the greater the trust, the bigger the disappointment. The rating agencies were over-trusted until 2007.

But looking forward, as a bi-polar sufferer might do, isn't the best strategy to try to manage this fundamental aspect of our identity by taking off the peaks and troughs of our swings in trust? In trading terms, if trust is the underlying commodity, we should manage our mood by selling an OTM call to fund a long OTM put and avoid capitulation here at the bottom of the trough in our trust.



## The Financial Stability Act of 2010

How does the financial reform act being considered in the US Senate address the rating agency problem? Two significant amendments were passed on May 13, one from Senator Franken and one from Senators LeMieux and Cantwell. They are bolder (or perhaps more theatrical) than the previous provisions and almost perfectly reflect each of the two very different strategies: improve credit ratings and eliminate credit ratings. It's not so clear if the amendments work well together or with the other CRA provisions of the current financial reform bill.

Prior to those amendments, the existing provisions in the bill sought to both improve and de-emphasize but not eliminate credit ratings. That's a good, sober approach that reflects the philosophy outlined by [Assistant Treasury Secretary Michael Barr](#) (Financial Institutions) in his remarks before the Banking committee in August:

“Our legislative proposal directly addresses three primary problems in the role of credit rating agencies: lack of transparency, ratings shopping, and conflicts of interest. It also recognizes the problem of over reliance on credit ratings and calls for additional study on this matter as well as reducing the over reliance on ratings.”

The Franken amendment would attempt to improve ratings by addressing the conflict of interest issue. In Franken's amendment, a Rating Advisory Board would be appointed by the SEC to assign one qualified NRSO to rate each securitization. The criteria for assignment could have a random component assuring that all qualified agencies get to rate some transactions but the Credit Rating Agency Board is directed to consider “the effectiveness of the methodologies used by the qualified nationally recognized statistical rating organization.” This seems to invite a contradiction of Secretary Barr's admonition that “the government should not be in the business of regulating or evaluating the methodologies themselves.”

Here's a [good description](#) of Franken's amendment with some context.

The LeMieux/Cantwell amendment cuts right through the problem of over reliance on credit ratings and ends Secretary Barr's time for additional study. It deletes all references to credit ratings from the Securities Exchange Act, the Investment Company Act of 1940 and the Federal Deposit Insurance Act. While not actually eliminating the NRSRO designation, [Senator LeMieux](#) describes his amendment as follows:

“My amendment writes these organizations out of law. . . . In a way, we're looking here and saying the astrology that we relied upon in the past didn't work. Let's have some new and better astrology.”

I don't fault the Senator for the astrology remark. Credit ratings are predictions about the future. My question is, “Where is this better astrology?” His amendment seeks to eliminate but not replace credit ratings in regulation. If you try to replace something with nothing, you create a vacuum. Ironically, one of the unintended consequences here could play right into the hands of S&P and Moody's. If you undermine the significance of the NRSRO designation, you risk hurting the seven newly minted NRSROs more than the well-known brand names.

In addition to the two recent amendments, the original rating agency-related provisions of the bill are [summarized here](#).

### New Requirements and Oversight of Credit Rating Agencies

- 1) New Office, New Focus at SEC: Creates an Office of Credit Ratings at the SEC with its own compliance staff and the authority to fine agencies. The SEC is required to examine Nationally Recognized Statistical Ratings Organizations at least once a year and make key findings public.
- 2) Disclosure: Requires Nationally Recognized Statistical Ratings Organizations to disclose their methodologies, their use of third parties for due diligence efforts, and their ratings track record.
- 3) Independent Information: Requires agencies to consider information in their ratings that comes to their attention from a source other than the organizations being rated if they find it credible.
- 4) Conflicts of Interest: Prohibits compliance officers from working on ratings, methodologies, or sales.
- 5) Liability: Investors could bring private rights of action against ratings agencies for a knowing or reckless failure to conduct a reasonable investigation of the facts or to obtain analysis from an independent source.
- 6) Right to Deregister: Gives the SEC the authority to deregister an agency for providing bad ratings over time.
- 7) Education: Requires ratings analysts to pass qualifying exams and have continuing education.

8) Reduce Reliance on Ratings: Requires the GAO study and requires regulators to remove unnecessary references to NRSRO ratings in regulations.

Here's how I rate these provisions.

(1) AA

This one should have been included in the CRA Reform Act of 2006 but better late than never. There are three big questions in my mind. a. What type of staff? Will it include some people with relevant experience either at rating agencies or at issuing or underwriting firms who have dealt with rating agencies?

b. Will the new focus at the SEC include the measurement of rating agency performance? The SEC needs to perform this critical task in-house, not wholly delegate it to the rating agencies themselves. Of course, this too has staffing implications.

c. How would fines be assessed? If properly targeted, fines could be a powerful tool to change incentives. For instance, the SEC could specify up front that financially painful fines will be levied for poor performance especially for an excess percentage of losses for ratings in the highest category.

(2) BB

Transparency is good except when it isn't. Rating agencies have been sharply criticized for revealing their methodology and thus allowing investment banks to "game" it. You cannot have it both ways. If a CRA has a transparent methodology, issuers or structuring bankers will use that knowledge to get better ratings. On balance I think transparency is good but issuers and underwriters will express strong opinions about anything that adversely affects them so investors and the SEC staff (see (1) above) need to voice their opinions about rating agency methodologies as well.

Regarding disclosure of rating agency track record, CRA's have always had staff publishing self-assessments. That's fine but it's very difficult to compare rating agency performance using their own idiosyncratic self-assessments. Surely the SEC needs to measure and publish comparative studies of rating agency performance (again see (1) above)

(3) CCC

Toothless. The information "considered" by the rater is irrelevant. It's the weight assigned to each piece of information that is critical. This is probably meant to help the plaintiff's bar in number (5) but I doubt it will.

(4) B

This is worth keeping in the bill but incredibly weak. Franken's amendment is definitely more effective at addressing the conflict of interest.

(5) B

OK but again weak. To avoid "knowing and reckless failures" the agencies will catalogue every conceivable risk in committee memos and thought pieces. I doubt this will affect actual rating decisions.

(6) A

Good but basically a nuclear option. The threat of deregistration is important but fines would be more helpful in practice to create incentives for better rating performance.

(7) BBB

Worth doing.

(8) AA

Good provision. Follows the main recommendation from Assistant Treasury Secretary Barr to the Senate Banking Committee in his testimony from August. LeMieux/Cantwell is a bridge too far.

## Improvements

Actually the bill may give the SEC all the power it needs but, how will the SEC use its new power? As Arturo Cifuentes

said in his testimony about CRA reform before Senator Levin's sub-committee on April 23, 2010, the current CRA regulations are like a building code that prohibits tall buildings but does not define tall. I agree.

The SEC needs to do three things.

(a) Define rating standards [but not methodology].

(b) Measure and publish rating performance.

(c) Impose fines for poor performance.

By way of example, there could be five simple categories: A for securities expected to lose under 0.1%, B for expected losses between 0.1% and 1%, C for expected losses from 1% to 5%, D for expected losses from 5% to 10% and F for securities expected losses between 10% and 20%.

As you can see, I would do away with AAA. The notion that an essentially riskless category exists should not be encouraged.

The fines would be heavy only for large-scale losses of securities with an A rating. Again, as an example, levy big fines for losses on A rated securities in excess of 10% for a given category and vintage or in excess of 1% across all categories and several years.

The fines help address the conflict of interest in the rating agency business. Rating agencies need restoration of the balance between rating performance against short term profitability. In the past, rating analysts expressing concerns about inflated ratings were seen only as threats to profitability. Fines do not guarantee accurate ratings but at least future rating agency employees who express concerns about inflated ratings have a chance of being seen as loyal employees working to ensure future profitability.

## Focus On This: Merkley-Levin Did Not Get A Vote

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The Baseline Scenario » 2010 » May 5/21/10 at 9:02 AM Simon Johnson

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*By Simon Johnson*

After 9 months of hard fighting, yesterday financial reform came down to this: [an amendment](#), proposed by Senators Jeff Merkley and Carl Levin that would have forced big banks to get rid of their speculative proprietary trading activities (i.e., a relatively strong version of the Volcker Rule.)

The amendment had picked up a great deal of support in recent weeks, partly because of unflagging support from Paul Volcker and partly because of the broader debate around the Brown-Kaufman amendment (which would have forced the biggest 6 banks to become smaller). [Brown-Kaufman failed, 33-61](#), but it demonstrated that a growing number of senators were willing to confront the power of our biggest and worst banks.

Yet, at the end of the day, the Merkley-Levin amendment did not even get a vote. Why?

Partly this was because of procedural maneuvers. Merkley-Levin could only get a vote if another amendment, proposed by Senator Brownback (on exempting auto dealers from new consumer protection rules) got a vote. Late yesterday afternoon, Senator Brownback was persuaded, presumably by his Republican colleagues and by financial lobbyists, to withdraw his amendment.

Of course, Merkley-Levin was only in this awkward position because of an earlier lack of wholehearted support from the Democratic leadership – and from the White House. Again, the long reach of Wall Street was at work.

But the important point here is quite different. If Merkley-Levin did not have the votes, it was in the interest of the megabanks to have it come to the floor and be defeated. That would have been a clear victory for the status quo.

But Merkley-Levin had momentum and could potentially have passed – reflecting a big change of opinion within the Senate (and more broadly around the country). The big banks were forced into overdrive to stop it.

The Volcker Rule, in its weaker Dodd bill form (“do a study and think about implementing”), perhaps will survive the upcoming House-Senate conference – although, because this process likely will not be televised, all kinds of bad things may happen behind closed doors. Regulators may also take the Volcker Rule more seriously – but the most

probable outcome is that the Fed and other officials will get a great deal of discretion regarding how to implement the principles, and they will completely fudge the issue.

Most importantly, everyone who wants to rein in the largest banks now has a much clearer idea of what to push for, what to campaign on, and for what purpose to raise money. This is the completely reasonable and responsible ask:

1. The Volcker Rule, as specifically proposed in the Merkley-Levin amendment
2. Constraints on the size and leverage of our largest banks, as proposed by the Brown-Kaufman amendment

When the mainstream consensus shifts in favor of these measures, or their functional equivalents, we will have finally begun the long process of reining in the dangerous economic and political power of our largest banks.

## The VC Tax Break

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The Baseline Scenario » 2010 » May 5/21/10 at 10:47 AM James Kwak

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*By James Kwak*

The House of Representatives is considering a bill that would [change the tax treatment of venture capitalists' income](#) (and that of private equity fund managers as well). Currently, VCs typically are paid “2 and 20” — that is, an annual fee of 2 percent of assets, plus 20 percent of profits. For example, let's say a fund starts out with \$200 million. Most of that money is invested by the fund's limited partners — pension funds, endowments, insurance companies, the usual suspects. After ten years (roughly the average life of a VC fund), the investments made by the fund are now worth \$400 million — a pretty humdrum return of 7 percent per year (before fees). The venture capitalists themselves will earn about \$14 million (\$200 million x 2% x 7 years)\* plus \$40 million (20% x (\$400 million – \$200 million)) equals \$54 million. (Note that they earn that \$40 million even for doing worse than the stock market's long-term average return.) The limited partners get what's left over after those fees. And before you start crying for the VCs, remember that a typical VC firm will have multiple VC funds going at once.

Right now, the \$14 million is taxed as ordinary income, but the \$40 million is taxed as capital gains — that is, at a tax rate of 15%. The bill would tax the \$40 million as ordinary income (actually, 75% as ordinary income and 25% as capital gains), for an effective tax rate of about 35%.

The current tax treatment has never made sense to me. The lower rate on capital gains is supposed to provide an incentive for capital investment.\*\* This is why, if you buy stock and sell it more than a year later, you pay tax on your gains at a lower rate. So clearly the actual investment returns on money invested in the VC fund should be treated as capital gains — but not the VCs' 20 percent fee, since that's compensation for fund management services, not returns on their investment. (VCs typically invest their own money in a fund, but it is only a small fraction of the whole, and no one is debating how that money should be treated.)

One argument I've heard is that the 20 percent comes out of the capital gains of the fund itself, so it should be treated as capital gains. But that's nonsense. If the limited partners got to keep it, it would be capital gains. Once they pay it to the VCs, it becomes an investment expense for the limited partners and a performance bonus for the VCs.

[Gerry Langelier](#), a venture capitalist, made a valiant effort to defend his tax break in the New York Times, but his arguments are so full of holes I wonder if even he believes them.

He starts off trying to equate the VCs' 20 percent to the profit a homeowner makes on the sale of his house.

“If you buy a house and take out a mortgage, you usually put a small percentage down, with the bank carrying the balance. To keep the math simple, say the house costs \$200,000 and you put down \$20,000. Ten years later, if you sell the house for \$300,000, you have a gain of \$100,000 on that \$20,000 investment. It is taxed as a capital gain because your capital was locked up for a prolonged time, there was a material risk of loss and the gain was not ‘guaranteed’ to you for just showing up every day, the way a salary is. You used the bank's capital as leverage on your \$20,000 investment, but that does not matter from a tax standpoint. Neither does the fact that you worked around the house over those 10 years to improve its value.

“Now, let's compare that with carried interest in a venture capital partnership. We in the industry invest a small percentage of the total dollars in our partnerships, like the house purchase above, with our limited partners investing the rest. Our investments are locked up for prolonged periods of time, often five to 10 years before we see any return. There is a real, material risk of loss of capital. In fact, many venture funds in the bubble lost money, including partners' capital. Like the house situation, our downside loss potential is ‘fixed’ by what we invested,

while our upside is unbounded.

“We do a lot of work ‘around the house’ to help our start-up companies grow. Our investors get their return on the profits we make. For those investors that are taxpaying entities, they pay tax on the gain at capital gains rates, just as they would if they had invested in a home. No one is proposing to change that tax treatment.

“If there is a profit on the entire partnership, then and only then do we as managers of those partnerships get our carried interest — usually about 20 percent of the total profit. That carried interest is delivered in the form of stock in those start-ups, stock that has been held for 5 to 10 years. Unlike our salaries (rightly taxed as ordinary income), the carried interest is not guaranteed by our just showing up, and it is only delivered if a long-term gain in the form of capital is created.

“Carried interest in a partnership bears a striking resemblance to our personal ‘carried interest’ in our homes.”

This argument ignores the difference between equity and debt. When you buy a house, your mortgage is debt. You are in the first loss position. When a VC puts some of his own money in his fund, that’s equity; it’s on an equal footing with the limited partners’ money, and they share losses proportionally. Investment gains on that money — the VCs’ actual investment in the fund — are already treated as capital gains; it’s the 20 percent we’re talking about here. Saying that a VC is “leveraging up” his investment in his fund with LPs’ money is nonsense. If Gerry Langelier really wants to put in all the equity in his VC fund and borrow the rest from investors — well, good luck trying to find people who will lend 90 or 95 percent of the money in a VC fund. If that’s what he’s doing, he’s getting 100 percent of the profits after servicing his debt, not 20 percent; that’s what owning all the equity means.

More fundamentally, even if the return profile of carried interest has a resemblance to the return profile of buying a house, that doesn’t make it capital gains. The fact that there’s risk involved doesn’t make something capital gains; if that were the case, then banks could start paying long-term bonuses (based on multiple years’ work) and calling that capital gains. The fact that the upside is unlimited doesn’t make something capital gains; if that were the case, then sales commissions would be capital gains. The fact that there’s downside . . . wait, there is no downside. If the fund loses money, the VCs don’t make up 20 percent of the losses to the limited partners. Their downside is restricted to their direct investment in the fund.

The second argument attempts to equate VCs to founders.

“In another example, closer to home, say an entrepreneurial team starts a business and raises money from venture capitalists. Those entrepreneurs pay ordinary income taxes on their salary (of course), but any gains on their stock — generated by leveraging our money and our help, as well as their hard work — are taxed as capital gains.

“The powers in Washington say that one rationale for taxing venture capitalists’ carried interest as ordinary income is that this is a ‘fee for service’ situation. But how is that different from an entrepreneur’s founders stock? He or she is being compensated based on the wealth created by direct labor. If ours is now a fee for service, then so is that of the entrepreneur. Can you imagine the uproar about stifling company formation and job growth if Congress suddenly chose to double the tax on entrepreneurs in this country?”

Again, Langelier can’t tell the difference between a founder and an investor. To start off, what does it mean to say that founders are “leveraging our money”? The concept of leverage only applies to *debt*. VCs invest by buying convertible preferred shares, which are a form of equity, not debt.\*\*\* They are buying a share of the company, and they get all the upside on that share. That’s not leverage. Seen purely from the standpoint of the capital structure, VC investments *dilute* the founders. Granted, the company is getting something valuable — cash — in exchange for that dilution. But it’s giving up some of the upside. That’s the *opposite* of leverage.

And if Langelier doesn’t know how VCs’ carried interest is different from founder stock, he doesn’t know how his business works. It typically works like this. At time zero, the founders decide to start a company and do some work. At time one, which could be the next day, they actually create the company and they invest all of the capital. At this point, they own the whole thing. And they keep working. From that point forward, the founders are compensated for their labor through their *salaries*, which are taxed as ordinary income. (And in most cases, the founders either pay themselves no salary or a considerably below-market salary for several years.) Someday they may sell their founder stock for a large gain, but they got that stock because they owned the company to begin with.

At time two, the VC fund comes along and buys a piece of the company. As part of that deal, one of the VCs gets a seat on the board of directors. At that point, he has a fiduciary obligation to act in the best interests of all of the shareholders. Any work he does for the company is in that capacity. He is working for the investors in the company. The limited partners want this, because if they’re going to put their money in a company, they want someone they trust (the venture capitalist) watching over that company. So the VC on the board is acting directly as a fiduciary for the shareholders and indirectly as an agent of the limited partners. That is why the LPs are willing to pay him 20 percent of

the profits. The fact that it's 20 percent of profits, rather than an amount that's fixed up front, makes it a bonus, and bonuses are always taxed as ordinary income; it doesn't make it a capital gain.

The compensation for both the work Langelier does as a board member and the work the founders do as employees should be taxed as ordinary income. Langelier wants the compensation for his *work* as a board member to be taxed the same way as the *appreciation* on the founders' initial ownership share in the company. That's not apples and oranges; that's apples and chartreuse.

Langelier continues:

"The gains of the limited partner investors in the stock owned by venture capital partnerships are taxed as capital gains. The gains by entrepreneurs on their stock holdings are taxed as capital gains. Under the new proposal, the *only* people taxed as ordinary income on the capital wealth created in that start-up would be the venture capital partners themselves."

Um, right. That's because the VC partners *didn't invest any of the capital*.\*\*\*\*

And it's worse than that. The last sentence in that excerpt is an insult to anyone who ever worked at a startup company but who was not a founder. Many early stage employees contribute much, much more to the "capital wealth created in that start-up" than any VC. For Langelier, they don't even exist.

(There's a similar but better argument made by [Bill Burnham](#) a few years ago: that the 20 percent is compensation for the venture capitalist's "sweat equity" for helping the company. But if you're going to make that argument, I don't see how you avoid acknowledging that founders also invest "sweat equity" beyond their actual capital contributions. Like the VCs, they own stock that everyone agrees should be treated as capital gains, and then they do some work. Why is the VCs' work any different from the founders' work? Especially when you consider that founders—and most early employees—are making considerably less than their opportunity costs, and hence their risk extends beyond their initial capital investments.)

There's more, but I'll stop there. Really, I have nothing against the VC industry. I regularly cite venture capital as one of the best parts of the financial system (and one that does not rely on anything that could be called "financial innovation"), my former company would not exist without VCs, and many of them are smart, hardworking people who have contributed greatly to the economy. Some VCs (well, [one at least](#)) are even in favor of the proposed tax change. The treatment of carried interest as capital gains is by no means the biggest problem with our tax code. I might be able to live with it if the argument were simply, "VCs are good, and this special perk is intended to provide an incentive for them to do what they do" ([Daniel Shaviro](#) thought about this line of argument, but wasn't particularly impressed).

In short, I wouldn't even have bothered with this post. Except that [duty called](#).

\* This isn't quite right, because the \$200 million is a capital commitment that gets drawn down, and the 2% fee is probably assessed on current asset value, not initial fund size, but this we're not discussing this part of the fee here.

\*\* I don't actually this is a good idea to start with. The premise is that people are irrationally conservative when it comes to preservation of capital. and hence you have to provide an incentive for them to put their capital at risk. But even if you accept that premise, the better solution is allow full refundability of losses — meaning that you get to take a tax deduction for all of your capital losses. That solves the problem more directly, since it provides a benefit in the state of the world that people want to be protected against, and it is less distorting. In any case, the effect of the lower capital gains tax rate is to lower taxes for rich people, since they are the ones with capital gains. But for the purposes of this post, let's just assume that capital gains are taxed at a lower rate than ordinary income.

\*\*\* Convertible preferred has debt-like features, but they only matter in a bad outcome (they give the VCs a disproportionate share of whatever value is left in the company). So from the founders' perspective, a VC investment provides the downside of debt, but not the upside.

\*\*\*\* Again, you can debate whether labor should pay higher taxes than capital — my instinct is that it shouldn't — but everyone, including Langelier, is taking that as a starting point for this debate.

## The Mystery of Capital

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The Baseline Scenario » 2010 » May 5/21/10 at 12:05 PM James Kwak

By James Kwak

So the dust has settled on the Senate bill, and it remains studiously vague about capital requirements — no hard leverage cap, for example. This is [what the administration wanted](#), for two reasons: first, they claim that regulators need ongoing flexibility to modify capital requirements; second, they claim that they need flexibility to negotiate a uniform international agreement.

There is one thing in there that is controversial enough to get the attention of the bank lobbyists: the [Collins Amendment](#), which [Mike Konczal](#) has written about here. The main provision of the amendment is that whatever capital requirements apply to insured depository institutions (banks), they also have to apply to systemically important financial institutions, including at the holding company level.

Sheila Bair of the FDIC is in favor of the amendment, on the argument that bank holding companies should not be able to evade capital requirements that are imposed on their subsidiary insured banks; she doesn't want to regulate the depository institutions but have all her work rendered irrelevant because the holding company collapses, triggering a mess of cross-guarantees.

This seems entirely unobjectionable, but as Konczal points out, the real threat to the banks is that it makes it harder for them to engage in financial engineering on the holding company level to evade capital requirements. According to the [Wall Street Journal](#), not only the banks, but also the administration itself is planning to try to kill this amendment (at this point, in conference committee).

The administration's argument, as mentioned above, is that these kinds of rules should be negotiated internationally, not set by Congress, which is overly political. But as [Bloomberg](#) pointed out earlier this week, international negotiations are nothing if not political. And as Konczal highlighted, the administration is also taking the banks' side in the international arena.

The Collins Amendment wants to make basic capital requirements simpler, with the option of adding more complex requirements on top ("shall serve as a floor for any capital requirements the agency may require"). Opponents want regulators to have as much discretion as possible. I think it's important to have a simple floor, because discretion and complexity are just a way of fooling ourselves into thinking we can measure something that is inherently unmeasurable.

A while back, [Steve Randy Waldman](#) weighed in on bank capital requirements. He goes much further and deeper than Simon and I did in [our article](#) about capital requirements. "Bank capital cannot be measured," he says. His point is both practical and epistemological.

On the practical side, look at Lehman: it was well capitalized on paper right before it collapsed, and then a few days later it had negative equity of at least \$20 billion. (And it wasn't because of some fire sale, Waldman explains.)

Here's the epistemological side (the part I like the most):

"Capital does not exist in the world. It is not accessible to the senses. When we claim a bank or any other firm has so much 'capital' we are modeling its assets and liabilities and contingent positions and coming up with a number. Unfortunately, there is not one uniquely 'true' model of bank capital. Even hewing to GAAP and all regulatory requirements, thousands of estimates and arbitrary choices must be made to compute the capital position of a modern bank. There is a broad, multidimensional 'space' of defensible models by which capital might be computed. When we 'measure' capital, we select a model and then compute. If we were to randomly select among potential models (even weighted by regulatory acceptability, so that a compliant model is much more likely than an iffy one), we would generate a probability distribution of capital values. That distribution would be very broad, so that for large, complex banks negative values would be moderately probable, as would the highly positive values that actually get reported. . . . Given the heterogeneity of real-world arrangements, no 'one-size-fits-all' model can be legislated or regulated to ensure a consistent capital measure. We cannot have both free-form, 'innovative' banks and meaningful measures of regulatory capital."

This is a point that I think is often lost. People talk about capital like levees to protect against a flood, but it's like levees that you can't see and measure, only guess at. Capital is probabilistic, so it's only as dependable as your ability to assess those probabilities.

And, of course, with banks the errors always come out the same way — overstating capital:

"For a long-term shareholder of a large financial, optimistically shading the firm's position increases both the earnings of the firm and the 'option value' of the firm in difficult times. It would be a massive failure of corporate governance if Jamie Dimon or Lloyd Blankfein *did not* fib a little to make their firms' books seem a bit better than perhaps they are, within legal and regulatory tolerances."



And here's Waldman's conclusion: "We need either to resimplify banks to make them amenable to the traditional approach, or come up with other approaches more capable of reigning in the brave new world of banking."

Ultimately, capital requirements alone are not the answer. But as long as we're going to base our banking regulation on them, we should make them as resistant to definition error and measurement error as possible.

## The Road To Economic Serfdom

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The Baseline Scenario » 2010 » May 5/23/10 at 8:03 AM Simon Johnson

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*By Peter Boone and Simon Johnson*

[According to Friedrich von Hayek](#), the development of welfare socialism after World War II undermined freedom and would lead western democracies inexorably to some form of state-run serfdom.

Hayek had the sign and the destination right but was entirely wrong about the mechanism. Unregulated finance, the ideology of unfettered free markets, and state capture by corporate interests are what ended up undermining democracy both in North America and in Europe. All industrialized countries are at risk, but it's the eurozone – with its vulnerable structures – that points most clearly to our potentially unpleasant collective futures.

As a result of the continuing euro crisis, European Central Bank (ECB) now finds itself buying up the debt of all the weaker eurozone governments, making it the – perhaps unwittingly – feudal boss of Europe. In the coming years, it will be the ECB and the European Union who dictate policy. The policy elite who run these structures – along with their allies in the private sector – are the new overlords.

We can argue about who exactly are the peasants, the vassals, and the lords under this model – and what services exactly will end up being exchanged. But there is no question we are seeing a sea change in the post-war system of property, power, and prosperity across Western Europe, just as Hayek feared. An overwhelming debt burden will bring down even the proudest people.

The ECB-EU approach will not of course return countries to reasonable levels of growth – the debt overhang is simply too large. The southern and western periphery of the eurozone cannot grow out of their debts under these arrangements, and so will stumble from stabilization program to stabilization program – just like Latin America did during the 1980s. This is bound to be acrimonious, leading to hostile politics, social unrest, and more economic crises.

The International Monetary Fund will do just what the EU and ECB asks to keep the charade in place. The old days when all member countries got nice presents from the euro zone are long gone; now it is all instructions and austere requirements. But enough resources will be provided to keep rolling everything over.

The top three French players – President Nicolas Sarkozy, Jean-Claude Trichet (ECB), and Dominique Strauss-Kahn (IMF) – seem to be enjoying themselves; presumably they think they will end up running things. More surprising is the reaction of other European leaders, who genuinely seem able to convince themselves that what they are doing makes sense – as opposed to being a series of crazed improvisations.

The market is telling them that their euro rescue schemes make no sense, and the market is probably right. Faced with the ugly reality of the loss of confidence in European finance and institutions, the Germans and even the normally sensible Swedish government are increasingly blaming "irrational" markets and speculators for homegrown problems.

The currently preferred messy solution of the EU leaves the world at risk of shocks like we observed this week. This particular iteration may blow over, but another will arise when there is backlash in Athens, Dublin, Lisbon, or – heaven forbid – Madrid.

Meanwhile, rational market participants are selling debt of risky nations, and getting out of the euro. The whole fiasco is now leading to a messy shift away from risky assets all around the world, and the cost to the world of such volatility is not small. Debt peonage looms for a wide range of countries that were recently thought immune to serious fiscal crisis, including the United States and UK.

It is inappropriate for the Europeans to subject the rest of the world to these large, chronic risks. Europe should also recognize how disorderly insolvencies end – it is never pretty. The 1970s crisis in Britain is the model for what may go wrong. Ongoing large strikes, populations disenchanted with all authority, and great economic disruption are

inevitably the outcome. When the assets are very cheap, deep-pocketed investors from the US, China, India and of course Russia will swoop in for the crown jewels.

What should be done? It is time to look in the mirror and recognize the problem. Several nations in Europe are bordering on insolvency, and it is now pretty clear that we shouldn't just "bandage" that over for a few years with large aid packages.

To deal with this insolvency we need to restructure the debts of those nations. But this has to be done in a way that does not destabilize Europe's fragile banking system. And it needs to be credible enough so that once restructured, the troubled nations will be able to finance themselves easily.

Europe now has the 750bn package of assistance in place, and they should use it to fix the problem once and for all. The ingredients for a solution include:

- Announcing an orderly restructuring of the periphery countries' debt (Greece, Portugal, Ireland and possibly others also). This should start with a standstill and a program of fiscal financing while budget cuts are put in place.
- Regulatory forbearance should be explicitly provided to all European banks, with a backstop of ECB liquidity, and a 500bn euro support program to provide capital injections – as was done in the United States, 2008-09.
- The nations that are not restructured need to be supported via ECB liquidity lines that guarantee the rollover of their government debt.
- The G20 needs to provide support to prevent chaotic foreign exchange markets but also accept a large further devaluation of the euro. At some point the G20 will need to intervene to support the euro via central banks.

Such a comprehensive package of measures would be painful, but it is the only realistic solution to this chaos. It would also restore some credibility to Mr. Trichet and the ECB, who, at this stage, appear captives the fiscal crises in the euro zone.

Unfortunately, there is no leadership today in Europe that could take such decisive actions, so Europe will only reform itself dragged kicking and screaming through successive crises until the current, and many ensuing, problems are resolved.

The UK and US need to prepare themselves for more storms. The United States will be in the more pleasant position as the world's safe haven, but this will only encourage America's profligate politicians to spend more and build more debt.

The UK will bear much more pain from euro devaluation and financial dislocation, all exacerbated by its own large deficit and debts. We might well see one more invasion across the channel, this time by bond vigilantes who question Britain's ability to rein in inflation as it builds too large debts.

At the end of this great tumult, Europe and the UK will have sound fiscal regimes. Debt will be defaulted on or inflated away, and nations will have dramatically cut spending.

Hayek's predicted demise of western society will prove correct, but welfare systems will prove the victim, rather than the mechanism, erased by a political and financial elite gone awry.

*An edited version of this article appeared [in the Sunday Telegraph \(UK\) this morning](#).*

## Why Does Steve Ballmer Still Have a Job?

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The Baseline Scenario » 2010 » May 5/24/10 at 10:51 PM James Kwak

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*By James Kwak*

So, after [questioning the iPad](#), I bought one.\* My primary motivation was that I wanted to be able to watch old TV episodes on the commute to and from my internship this summer, and I think an iPod Touch is just too small. I also bought an Android phone, because my three-year-old Motorola RAZR2 v9m (who comes up with these product names, anyway?) developed a crack in the hinge, and because I wanted the best camera I could get on a phone. (My #2 use for a phone is not email — it's taking pictures and videos of my daughter.)

Anyway, catching up on the last three years of mobile technology has provided ample food for thought. I have a long post on the Apple-Google(-Microsoft) war rolling around in my head somewhere, which I will hopefully write down later this week. In the meantime, here's [John Gruber](#)'s verdict on Microsoft:

“Three years ago, just before the original iPhone shipped, here’s what [Steve Ballmer said in an interview with USA Today’s David Lieberman](#):

‘There’s no chance that the iPhone is going to get any significant market share. No chance. It’s a \$500 subsidized item. They may make a lot of money. But if you actually take a look at the 1.3 billion phones that get sold, I’d prefer to have our software in 60 percent or 70 percent or 80 percent of them, than I would to have 2 percent or 3 percent, which is what Apple might get.’

“Not only was he wrong about the iPhone, but he was even more wrong about Windows Mobile. Three years ago Ballmer was talking about 60, 70, 80 percent market share. This week, [Gartner reported that Windows Mobile has dropped to 6.8 percent market share](#) in worldwide smartphone sales, down dramatically from 10.2 percent a year ago.”

Steve Ballmer has been CEO of Microsoft since 2000. During his tenure, Microsoft came out with Windows Vista, perhaps the most unsuccessful operating system in modern history (Windows ME doesn’t count, since Microsoft’s core customer base was using NT/2000); it tried a “Microsoft inside” strategy in digital music and, when that failed, launched the Zune, which also failed; it watched Firefox (and Safari and Chrome) eat a large chunk of its lunch in Internet browsers, the application most people use more than everything else put together; it launched Windows Live, a marketing strategy with no noun behind it, which completely flopped at whatever it was supposed to do; it got blown away in Internet search to the point where it had to re-launch as Bing, a plucky underdog; and in mobile phones, which everyone has known for a decade would be the next big thing, it stuck with its bloated, awkward Windows Mobile for far too long, letting *everyone* (RIM, Apple, Google, and even Palm) pass it by to the point where it has no customer base left. (BlackBerry rules the corporate market, Microsoft’s traditional stomping grounds.) Recently I saw a headline saying that Microsoft is going to try to relaunch Hotmail to make it cool. Really, why bother?

Sure, Microsoft still has a dominant market share in PC operating systems and office applications, but it’s managed to take that massive competitive advantage and waste it everywhere else over the past decade. It hasn’t even managed to become a major player in enterprise applications, a market that is desperately crying out for new competition, and where Microsoft should have been able to muscle its way in using its existing relationships with corporate CIOs and procurement officers. Is Bill Gates just too loyal to his old friend?

As for the iPad: I agree with Brad DeLong that the biggest problems with the keyboard are (a) hitting the shift key instead of “A” and (b) needing to shift to the numeric/symbol keyboard just for an apostrophe or a quotation mark. I would add the lack of control key sequences. It’s remarkably comfortable to interact with, to the point where I use it sometimes when a laptop would be more efficient, simply because it’s more pleasant. (For one thing, it doesn’t constrain your physical position the way even a laptop does.) It’s also much nicer to have in a non-work part of the house, like the kitchen or living room, even than a laptop, which feels clunky and intrusive by comparison. And my daughter loves [Fish School](#). But using it is still a constant exercise in compromises, largely because of the keyboard (it works, but it takes effort, as opposed to a regular keyboard) and also because some web sites don’t behave properly (and there is the Flash problem).

And there is the whole over-hyped apps model, which will be the topic of a future post that will be more original than this one.

\* Although I did say this: “I think it will still be a success, though not nearly as big as the iPod or iPhone. I think so for two reasons: first, the product probably is just better than anything else in the category; and second, the Apple fan base is so big and so devoted that it will have blowout initial sales and then build momentum of its own.”

## Regulation vs. Structural Change

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The Baseline Scenario » 2010 » May 5/25/10 at 9:31 AM James Kwak

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By James Kwak

[Robert Reich](#) discusses a theme that I think I’ve discussed before (and first heard expressed by Ezra Klein):

“The most important thing to know about the 1,500 page financial reform bill passed by the Senate last week — now on he way to being reconciled with the House bill — is that it’s regulatory. It does nothing to change the structure of Wall Street.”

Reich’s post weirdly cuts off in the middle on his site, but [Mark Thoma](#) has a longer excerpt. In that excerpt, Reich

concludes this way:

“The only way to have a lasting effect on industries as large and intransigent as banking and health care is to alter their structure. That was the approach taken to finance by Franklin D. Roosevelt in the 1930s, and by Lyndon Johnson to health care (Medicare) in the 1960s.

“So why has Obama consistently chosen regulation over restructuring? Because restructuring Wall Street or health care would surely elicit firestorms from these industries. Both are politically powerful, and Obama did not want to take them on directly.”

I would add that Obama is also a political pragmatist with a strong belief that getting something done is better than nothing. I think that on health care he and the administration probably did the best they could. Remember, they barely got a majority in the House, then barely got sixty votes in the Senate, then barely got a majority in the House again (to pass the revised bill), and public opinion was very divided.

But on financial reform I think they could have gotten more done. First of all, public opinion wanted more; and second, the administration lobbied *against* some of the most far-reaching changes, such as Kaufman-Brown and Blanche Lincoln’s derivatives spinout provision, and Merkley-Levin never got a vote. The whole theater of the administration trying to put the bill into stone before it got much stronger should have been embarrassing to them, but they decided they could take the hit.

I think the explanation for this is some combination of (a) the economic policy guys really think that the financial system we have today is basically fine and just needs a little better oversight and (b) Obama just doesn’t care that much and wants to save his political capital (and his support from the financial sector) for other issues, like (hopefully) jobs and climate change.

Here’s Thoma’s conclusion:

“Structural change is harder than imposing new regulations. The fact that legislators are shying away from the harder to impose types of change out of fear of losing reelection support from the financial industry points to the political power the industry still has, and to the need for structural change to reduce this political (and economic) power. If we cannot muster the political will to make such changes in light of the most devastating financial collapse since the Great Depression, that does not bode well for the future.”

## The Last Hold Out: Senator Blanche Lincoln Against 13 Bankers

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The Baseline Scenario » 2010 » May 5/26/10 at 7:26 AM Simon Johnson

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*By Simon Johnson*

By now you have probably realized – correctly – that “financial reform” has turned into a victory lap for Wall Street.

When they saved the big banks, with massive unconditional support (both explicit and implicit) over a year ago, top administration officials promised they would be back later to fix the underlying problems. This they – and Congress – manifestly have failed to do.

Our banking structure remains unchanged, the rules will be tweaked at the margins, and the incentive and belief system that lies behind reckless risk-taking has only become more dangerous. (The back story, if you can still stomach it, is in [13 Bankers](#)).

There is only one small chance for any sensible progress remaining – and you are about to see this crushed in conference by the supporters of unfettered big banks.

Senator Blanche Lincoln’s proposal with regard to derivatives has much to commend it. A fiduciary duty for swaps dealers vis-à-vis customers would be entirely appropriate – in fact long overdue.

Real time price reporting should also help regulators at least begin to understand what is driving market dynamics, for example around the May 6 “flash crash” – a point that Senator Ted Kaufman has also been [making most forcefully](#).

Legal authority against market manipulation would be greatly strengthened and there would be more protection for whistleblowers. And the kind of transaction that [Goldman entered into with Greece](#) – a swap transaction with the goal of reducing measured debt levels, effectively deceiving current and future investors, would become more clearly

illegal. All of this is entirely reasonable and responsible – and completely opposed by the most powerful people on Wall Street.

Of course, most of the anti-Lincoln fire has been directed against the idea that “swaps desks” would be “pushed out” to subsidiaries – i.e., the big broker-dealers could still engage in these transactions, but they would need to hold a great deal more capital against their exposures, thus making the activities significantly less profitable.

It is striking that while Treasury argues that increasing capital is the way to go with regard to financial reform, they are adamantly opposed to what would amount to more reasonable capital levels at the heart of the derivatives business.

This is beyond disappointing.

No doubt the administration feels good about what it has “achieved” on financial reform. The public aura of mutual congratulation will last for about three weeks.

But outside of the inner White House-Capitol Hill bubble, it is very hard to find anyone well-informed about the financial system who thinks that anything substantial has changed or that risks will be better managed as we head into the next cycle.

“Business as usual” is the abiding legacy of the Obama administration with regard to the systemic risks posed by this financial system. Treasury and White House let us down repeatedly and completely in the last 18 months on financial sector issues – just as they did (as decision-making bodies and as some of the same individuals) at the end of the 1990s.

At one point in early 1998, Larry Summers called Brooksley Born – the last person who really tried to rein in the dangers posed by derivatives (and it was a much lower level of danger then compared with now). [Summers reportedly said](#), “I have thirteen bankers in my office, and they say if you go forward with this you will cause the worst financial crisis since World War II.”

We now seem to have come full circle to exactly the same people saying exactly the same things – no doubt top people in the administration are now calling Senator Lincoln and impressing upon her a version of the same point made by Summers to Born.

The 13 bankers have won, completely. Here we go again.

## Wall Street CEOs Are Nuts

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The Baseline Scenario » 2010 » May 5/26/10 at 10:15 AM James Kwak

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By James Kwak

“Geithner’s team spent much of its time during the debate over the Senate bill helping Senate Banking Committee chair Chris Dodd kill off or modify amendments being offered by more-progressive Democrats. A good example was Bernie Sanders’s measure to audit the Fed, which the administration played a key role in getting the senator from Vermont to tone down. Another was the Brown-Kaufman Amendment, which became a cause célèbre among lefty reformers such as former IMF economist Simon Johnson. ‘If enacted, Brown-Kaufman would have broken up the six biggest banks in America,’ says the senior Treasury official. ‘If we’d been for it, it probably would have happened. But we weren’t, so it didn’t.’”

Oh, well.

That’s one passage from John Heileman’s juicy article in [New York Magazine](#). It provides a lot of background support for what many of us have been [thinking for a while](#): the administration is happy with the financial reform bill roughly as it turned out, and it got there by taking up an anti-Wall Street tone (e.g., the Volcker Rule), riding a wave of populist anger to the point where the bill was sure of passing, and then quietly pruning back its most far-reaching components. If anything, that’s a testament to the political skill of the White House and, yes, Tim Geithner as well.

There are two other things in the article I thought worth commenting on. Here’s one:

“Obama could be forgiven for expecting greater reciprocity from the bankers—something more than the equivalent of a Hallmark card and a box of penny candy. He had, after all, done more than saved their lives directly by continuing the bailout policies formulated by Paulson and Geithner. He and his team could credibly claim to have

kept the world economy from falling off a cliff. Yet with the unemployment rate still near double digits, Obama had (and still has) received scant credit from the public for what was arguably his signal accomplishment. At the same time, the one thing that almost every slice of the electorate *would* have applauded wildly—the sight of the president landing a few haymakers on Wall Street’s collective jaw—was an opportunity that the president had largely forsworn.”

This is a theme you hear a lot these days — the idea that Obama (or Geithner) could have taken the easy political road and bashed Wall Street, but that would have been bad for the economy, so instead he acted like a man and saved the economy, even if it was bad for his poll numbers. But this little bit of mythologizing rests on a flawed premise. Yes, stabilizing the economy was a top priority in early 2009, and for the most part it worked. (Have you seen the [CBO's estimate](#) of the impact of the stimulus on GDP growth rates? Hint: it's big.) But that did not and does not preclude “landing a few haymakers on Wall Street’s collective jaw.” Just because you follow one set of policies in early 2009 to stabilize the economy, that doesn’t mean that in late 2009 and early 2010 you can’t then properly fix the financial system that caused the damage in the first place.

The other, and perhaps most important thing Heileman’s article shows is that Wall Street executives are a *bunch of raving lunatics*. Here’s one paragraph:

“Today, it’s hard to find anyone on Wall Street who doesn’t speak of Obama as if he were an unholy hybrid of Bernie Sanders and Eldridge Cleaver. One night not long ago, over dinner with ten executives in the finance industry, I heard the president described as ‘hostile to business,’ ‘anti-wealth,’ and ‘anti-capitalism’; as a ‘redistributionist,’ a ‘villifier,’ and a ‘thug.’ A few days later, I recounted this experience to the same Wall Street CEO who’d called the Volcker Rule a testicular blow, and mentioned I’d been told that one of the most prominent megabank chiefs, who once boasted to friends of voting for Obama, now refers to him privately as a ‘Chicago mob guy.’ Do all your brethren feel this way? I asked. ‘Oh, not everybody—just most of them,’ he replied. ‘Jamie [Dimon]? Lloyd [Blankfein]? They might not say Obama’s a socialist, but they come pretty close.’”

This is wingnut, Tea Party, willful blindness to reality kind of stuff. Forget the whole issue of whether they should be grateful to Obama for first saving their banks from collapse and then toning down the reform bill so it (a) doesn’t break up their banks, (b) doesn’t meaningfully prevent them from engaging in proprietary trading, (c) says nothing of substance about compensation, (d) doesn’t set any hard capital requirements, (e) . . . The fact that they can see the policies this administration is pursuing and somehow think they are “anti-wealth” or “anti-capitalist” is as close to proof as you will find that they are deeply stupid, blinded by their self-interest, or both.

The White House/Treasury narrative is that they were the adults — they made the tough calls that needed to be made instead of taking the easy road politically. The Wall Street narrative is the exact opposite: the administration is a bunch of political hacks, not the adults you need to have in charge. Here’s what one lobbyist said about the AIG bonus controversy:

“First, the White House decides in this blatant way to politicize the issue. Second, they overshoot the target and the thing gets away from them. It made people realize there’s no adult in charge. If Bob Rubin or Hank Paulson were Treasury secretary, they would have walked into the Oval Office and said, ‘Mr. President, I know you’d like to do this, I know your political advisers want you to do this, but I’m sorry, you can’t do this.’”

Bob Rubin and Hank Paulson, of course, were both former chairmen of Goldman Sachs.

Wall Street CEOs like to think they are the adults, the big men in the room, the ones who know how the world works. Well, you know what? They screwed up their own banks, the financial system, and the economy like a bunch of two-year-olds. Every single major bank would have failed in late 2008 without massive government intervention — because of wounds that were entirely self-inflicted. (Citigroup: holding onto hundreds of billions of dollars of its own toxic waste. Bank of America: paying \$50 billion for an investment bank that would have failed within three days. Morgan Stanley and Goldman Sachs: leveraging up without a stable source of funding. Etc.) The financial crisis should have put to rest for a generation the idea that the big boys on Wall Street know what they’re doing and the politicians in Washington are a bunch of amateurs. Yet somehow the bankers came out of it with the same unshakable belief in their own perfection that they had in 2005. The only plausible explanation is some kind of powerful personality disorder.

The bankers also have this bizarre belief that the administration has somehow betrayed them — that this year’s supposed shift to the left constituted reneging on some kind of deal. But there have to be two parties to a deal — and what did the banks do for Obama? They didn’t put in place any kind of self-regulation — not when it comes to compensation, capital, risk management, securitization, derivatives, or anything. They didn’t cut back bonuses to merely outrageous levels, although Goldman did decide not to pay itself *record* bonuses when it could have. They fought the stress tests all the way to the end, too blind to realize that the stress tests, and the government guarantee they implied, were the key to *their* salvation.

The administration owed them nothing. The bankers are playground bullies who are used to getting their way and think that if they're not getting their way, someone must be cheating them. But the government is the biggest bully on the playground. Congress and the president get to make up the laws; that's what it says in the Constitution. The government doesn't need to do a deal with Wall Street to regulate it. It *always* has the power to pass whatever law it wants regarding the financial sector; it doesn't need permission (even if it acted that way for the past two decades). The bankers should be relieved that the administration happens to support policies that are relatively friendly to their interests. Instead, they are complaining as if the administration broke some kind of rule.

(Now, you could say Obama has a debt to Wall Street because of all the money it gave him in 2007-08. But I dare any Wall Street CEO to come out and say that. And besides, the politically rational thing to do is to look forward. And, as [Politico](#) reported, Wall Street has been shifting its money to Republicans recently.)

And so, in one corner, we have a bunch of Wall Street CEOs sulking, deluding themselves into thinking that Barack Obama is a socialist, and probably planning to give money to Sarah Palin (which would be a colossal blow to their own self-interest). In the other corner, we have Obama and Geithner wondering why those Wall Street CEOs aren't showing more gratitude.

“‘[Obama] thinks the Wall Street guys are just disconnected from reality,’ says a White House official. ‘He still takes the meetings with them, but his attitude now is like, “Whatever.”’

“Tim Geithner, too, finds himself in the odd position of battling with an industry toward which he's never felt an ounce of antipathy; in private, he now half-mockingly refers to the megabank CEOs as ‘the warlords.’ A Washington Mandarin to his core, Geithner has been ineffective at winning over either Wall Street or Main Street. His experience during his tenure has provided him a wrenching political education, but one not unlike Obama's—which, in a way, has only strengthened the bond between them.”

Yes, they deserve more gratitude. They saved the bankers twice — once by protecting them from their own mistakes, and again by protecting them from Sherrod Brown, Ted Kaufman, and all the other “populists” who wanted fundamental changes in our financial system. As should be clear, for all my differences with Tim Geithner, I would rather have him calling the shots than Jamie Dimon or Lloyd Blankfein.

But Obama and Geithner should know better than to expect gratitude from a bunch of narcissistic, delusional crybabies. And in that sense, both parties to this toxic relationship — the Wall Street bankers and the Obama administration officials — deserve each other.

## So Damn Little Money

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The Baseline Scenario » 2010 » May 5/27/10 at 8:16 AM Simon Johnson

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*By Simon Johnson*

The financial reform legislation currently heading into a June [Senate-House conference](#) will, at best, do little to affect the incentives and [beliefs at the heart of the largest banks](#) on Wall Street. Serious attempts to strengthen the bill through amendment — such as [Brown-Kaufman](#) and [Merkley-Levin](#) — were either shot down on the floor of the Senate or, when their prospects seemed stronger, not allowed to come to a vote.

[Senator Blanche Lincoln is holding the Alamo](#) with regard to reining in the big broker-dealers in derivatives. But these same people are bringing to bear one of the most intensely focused lobbying campaigns of recent years, bent on killing her provisions (or weakening them beyond recognition). All the early indications are that the lobbyists, once again, will prevail.

At one level, [Robert Kaiser nailed this topic](#) in his recent book, “So Damn Much Money: The Triumph of Lobbying and the Corrosion of American Government.” Elections have become more expensive, with most of the funding provided by special interests. You can argue about which is the chicken and which is the egg, but the basic facts are inescapable.

“In 1974, the average winning campaign for the Senate cost \$437,000; by 2006, that number had grown to \$7.92 million. The cost of winning House campaigns grew comparably: \$56,500 in 1974, \$1.3 million in 2006.”[\[1\]](#)

Or look at the [lifetime contributions by the financial sector](#) to (some) senators who voted for and against the Brown-Kaufman amendment, which would have imposed a hard size cap and a hard leverage cap on the biggest banks —



over \$2 million per senator by this one partial count.

But wait. This is actually very little money considering what is at stake. For an individual large firm actively engaged in derivatives trading, the stakes could easily be in the billions of dollars. For the big banks as a whole, the amount they will be allowed to earn (and pay themselves) as a result of the failure of these financial reforms is – conservatively speaking – in the tens of billions of dollars.

In terms of modern Wall Street – for top bankers and also for hedge funds – the political contributions needed to make a difference are chump change.

And even if opponents of today's biggest players on Wall Street were to become organized and raise money, presumably the big financial players could see that money and raise you some tens of millions of dollars without breaking a sweat (particularly after the [Citizens United decision by the Supreme Court](#)).

What can you possibly propose that would make a difference in the face of such resources – for example, as they will be deployed in and around the upcoming House-Senate conference to make sure that anything at all objectionable to Wall Street is further diluted?

Here's the one idea (not mine, but the source prefers to remain anonymous): counter the money of Wall Street by bringing much more transparency to the conference.

Televising the conference meetings could help, but realistically this is also likely to push the substantive decision-making and discussion off-line. Therefore, in addition, congressional leaders should be pressed agree to three non-waiveable rules for the conference and the conference report on the Wall Street reform bills:

1. Any amendments need to be posted on-line not less than three business days before any relevant conference meeting. Second degree amendments (i.e., those filed as amendments to amendments) need at least 2 days notice on the same basis.
2. The House and the Senate will not discuss any conference report until the report as amended by the conference has been posted on-line in its entirety for at least 5 business days.
3. A red lined version of the conference report as amended – to show all changes – must also be posted on-line for not less than 5 business days before any vote on that conference report.

Without such provisions – which, by the way, are unlikely to be adopted – no one excluded from the backrooms will have the opportunity to learn what the amendments do or what is in the bill itself.

The point is not that this would necessarily stop the final and nearly complete victory of special interests. But at least we will learn which members of Congress exactly sided with them, on why, and even why. And this will help a great deal as we think about how best to move forward.

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

## Good Government vs. Less Government

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The Baseline Scenario » 2010 » May 5/27/10 at 11:29 PM James Kwak

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*Or: Why the Heritage Freedom Index is a Damned Statistical Lie*

*This guest post was contributed by StatsGuy, a frequent commenter and occasional guest on this blog. It shows how quickly the headline interpretation of statistical measures breaks down once you start peeking under the covers.*

Recently, a [controversy raged](#) in the [blogosphere](#) about whether [neo-liberalism](#) has been a bane or a boon for the world economy. The argument is rather coarse, in that it fails to distinguish between the various elements of neo-liberalism, or moderate deregulation vs. extreme deregulation. But if we take the argument at face value, one of the major claims of neoliberals is that countries in the world which are more neoliberal are more successful (because they are more neoliberal). I disagree.

My disagreement is not with the raw correlation between the Heritage Index and Per Capita GDP. A number is a number. My disagreement is with the composition of the index itself, and interpreting this correlation as causation between neo-liberalism and 'good things.'

My primary contention below is that many of these measures used in the composite Heritage Index have nothing to do with **less government**, and a lot more to do with **good government**. It is these measures of good government that correlate to economic growth and drive the overall correlation between the “Freedom Index” and positive outcomes. Secondly, I will argue that many of the *other* items in the index (like investment freedom) are not causes of growth, but rather outcomes of growth.

The Heritage Index weighs ten items equally, and these items are derived using very different mechanisms (many subjective):

- Business Freedom
- Trade Freedom
- Fiscal Freedom
- Government Freedom
- Monetary Freedom
- Investment Freedom
- Financial Freedom
- Property Freedom
- Freedom from Corruption
- Labor Freedom

Here are the top twenty countries on the index, and their overall scores.

Hong Kong	89.7
Singapore	86.1
Australia	82.6
New Zealand	82.1
Ireland	81.3
Switzerland	81.1
Canada	80.4
United States	78
Denmark	77.9
Chile	77.2
United Kingdom	76.5
Bahrain	76.3
Mauritius	76.3
Luxembourg	75.4
The Netherlands	75
Estonia	74.7
Finland	73.8
Iceland	73.7
Japan	72.9
Macau	72.5

It strikes many that some countries we do not normally consider very libertarian rank quite high – Singapore (with the government [actively manipulating](#) the property market through its monopoly on land sales, or deploying investments through its massive [sovereign wealth fund](#), etc.), Canada (with its state run health system), and others.

Likewise, on the negative side of the equation, we can observe several countries that score in the upper third on the

Heritage Index that strike us as weak states. It turns out that Jamaica scores a rank of #58, and Colombia a #57. This is well above a lot of other countries like Argentina (#135), and even slightly above relatively successful nations like France (#63), Poland (#70), and Italy (#73). These types of scores tend to raise questions.

If we look under the hood, it turns out that Jamaica would score *even better* on the Heritage Index if it weren't for two components on which it scores miserably. Here are Jamaica's scores:

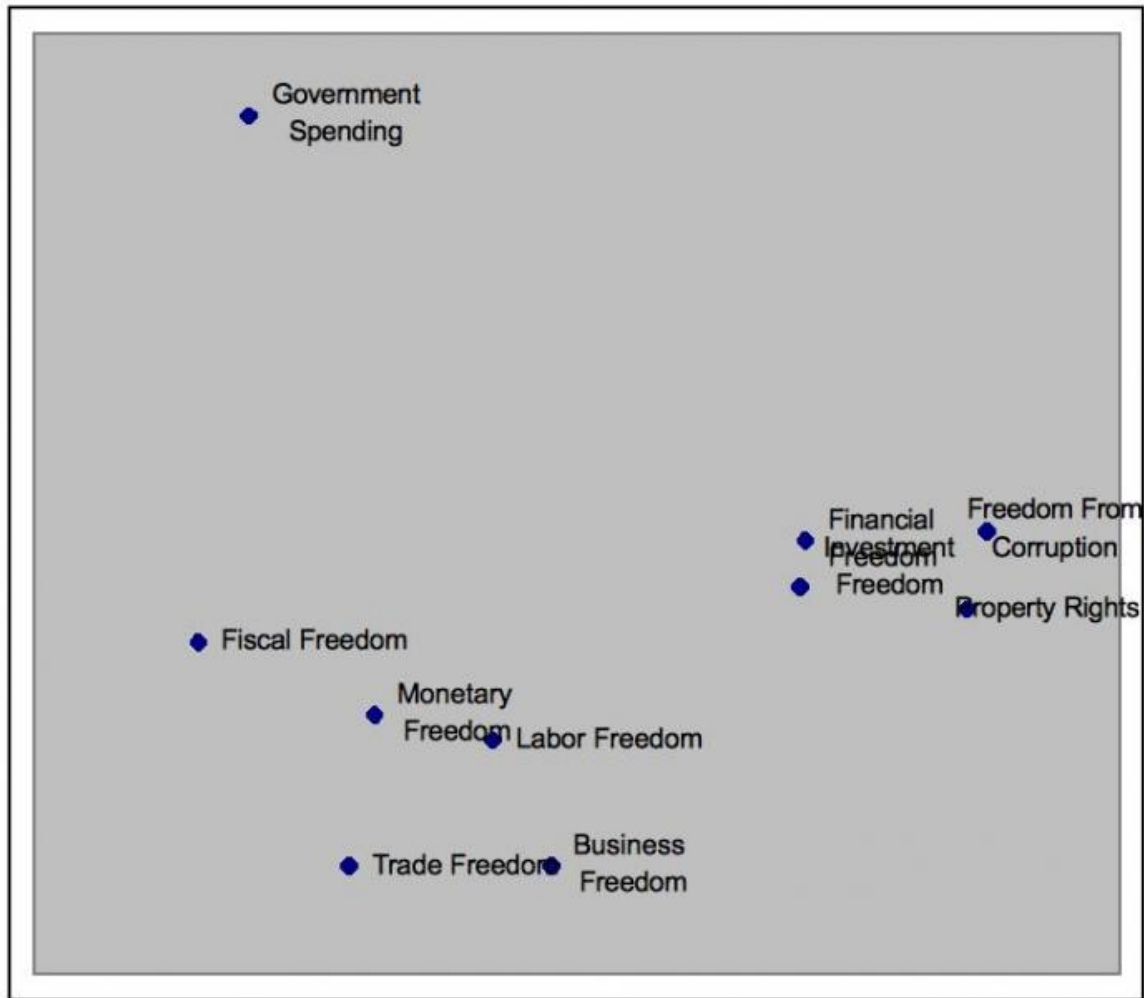
Overall Score	65.5
Business Freedom	87
Trade Freedom	72.2
Fiscal Freedom	74.8
Government Spending	61.8
Monetary Freedom	68.4
Investment Freedom	85
Financial Freedom	60
<b>Property Rights</b>	<b>45</b>
<b>Freedom From Corruption</b>	<b>31</b>
Labor Freedom	70

Those two scores are massively dragging down the average. This immediately makes one wonder how the various components relate to each other. Let's take a look at the simple correlations:

[illegible]

Corruption	0.79	0.69	0.51	-0.32	-0.40	0.56	0.68	0.67	0.94	1.00	0.29
Labor Freedom	0.45	0.44	0.15	0.13	-0.13	0.13	0.13	0.24	0.29	0.29	1.00

Wow, there are some peculiar things about this table! Note, for instance, that Government Spending is negatively correlated with just about everything (except Fiscal Freedom). Note, also, that Property Rights and Freedom From Corruption have the highest bivariate correlation on the table (0.94). What if we were to try to visualize the relationships between the Heritage Index components, for example using a tool like [MDS](#)? We might get this (depending how you run it):



At first glance, it looks there are three groups of items: one focusing on property rights, corruption, and financial “freedom”; one focusing on structural factors in the economy (trade, business, labor, monetary); and one focusing on government spending (with fiscal freedom somewhere between government spending and the structural factors).

Let’s dig even deeper. If we open up the criteria for Financial and Investment Freedom, we find that both of these are subjective measures – using a point system in which Heritage deducts points depending on government interference with investments and finance. Subjective measures are problematic, because the individuals assigning points probably have a high bias to (unintentionally) favor countries that are successful overall. (That’s why drug trials require double blind tests.) But let’s give them the benefit of the doubt.

For Investment Freedom, Heritage penalizes points for several reasons, but half of the measure relates to legal recourse against appropriation of investor funds, bureaucratic controls over capital movement, and lack of transparency in investment law. . . . These sure sound a lot like Property Rights and Freedom From Corruption. For Financial Freedom, Heritage uses a 0-100 scale that is subjectively assigned based on the reviewer’s perceived influence of the government on finance. On this scale, the United Kingdom, which unleashed massive Quantitative Easing (not that I’m critical) and has tight links between large banks and Parliament scored an 80, near the top of the chart.

What about the variables in the lower left quadrant? Well, some of them we can probably ignore, like Monetary Freedom, which basically measures inflation and price controls. If we look at the standard deviation of these 10 measures across all countries, we get an idea of the typical influence of each variable on the final index score.

Measure	Standard Deviation
Business Freedom	18.0
Trade Freedom	12.1
Fiscal Freedom	12.7
Government Spending	20.4
Monetary Freedom	6.9
Investment Freedom	22.0
Financial Freedom	19.0
Property Rights	24.0
Freedom From Corruption	21.0
Labor Freedom	17.2

Monetary Freedom is flat, meaning that on average it accounts for little variation in the index score among countries. Property Rights and Freedom from Corruption typically account for three times as much variation in the final index. Even Trade Freedom and Fiscal Freedom are relatively flat compared to Property Rights and Freedom From Corruption. As one can see, the final index is (empirically) heavily weighted toward what I will call the 'Good Government' variables, rather than the 'Less Government' variables.

But let's go just one step further. Let's pull a measure of quality of life from the World Bank that uses something other than GDP. We'll use Life Expectancy. While this is surely influenced by genetics, one must imagine it's a pretty decent measure of quality of life as well. How does this measure correlate with the ten 'Freedom' measures above?

Measure	Correlation With Life Expectancy
Overall Score	0.59
Business Freedom	0.60
Trade Freedom	0.53
Fiscal Freedom	-0.01
Government Spending	-0.27
Monetary Freedom	0.30
Investment Freedom	0.46
Financial Freedom	0.47
Property Rights	0.61
Freedom From Corruption	0.64
Labor Freedom	0.17

Wow . . . Fiscal Freedom and lower Government Spending *negatively correlate* with life expectancy, even without controlling for other variables! A purist might observe that government spending could be an outcome, rather than a cause (i.e., government spending is a luxury good that wealthy societies engage in by mistake, but it doesn't improve mortality rates). That sounds fishy, but even so, it still undercuts the neoliberal argument (less government = always better). Likewise, we observe very low correlations with Labor Freedom and Monetary Freedom, and one could argue

that most of that correlation is spurious (that is, working through other factors).

Where are the **highest** correlations? Property Rights and Freedom from Corruption. . . . Again, our best measures of 'Good Government' in this index.

The second strongest pair of measures – Business Freedom and Trade Freedom – does seem to support the neo-liberal case. I will note, however, that Business Freedom is primarily determined by the speed/cost of starting, licensing, and closing a company. I will further note that this is *heavily* influenced by the efficiency of licensing agencies and the court system (especially bankruptcy courts). Again, these are measures of 'Good Government.' The neo-liberals do seem to have a case for lower trade barriers ('Trade Freedom'), although a huge part of this correlation is driven by the fact that the entirety of Europe has relatively low trade barriers.

## Conclusion

The Heritage Freedom Index is really a composite of measures that get at two different things: Good Government, and Less Government. Overall, the Good Government factors tend to dominate, and drive a lot of the correlation with good economic and quality of life outcomes. When one splits out the factors, the case for Less/Weaker Government weakens substantially, and the case for Clean/Non-Corrupt/Efficient government strengthens considerably.

This does not support many of the conclusions that are often drawn using the overall Heritage Index.

## Is The SEC Still Working For Wall Street?

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The Baseline Scenario » 2010 » May 5/28/10 at 6:04 AM Simon Johnson

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*By Simon Johnson*

The Securities and Exchange Commission (SEC) under Mary Shapiro is trying to escape a difficult legacy – over the past two decades, the once proud agency was effectively captured by the very Wall Street firms it was supposed to regulate.

The SEC's case against Goldman Sachs may mark a return to a more effective role; certainly bringing a case against Goldman took some guts. But it is entirely possible that the Goldman matter is a one off that lacks broader implications. And in this context the SEC's handling of concerns about "high frequency trading" (HFT) – following the May 6 "flash crash", when the stock market essentially shut down or rebooted for 20 minutes – is most disconcerting. (See yesterday's [speech by Senator Ted Kaufman on this exact issue](#); [short summary](#).)

Regulatory capture begins when the regulator starts to see the world only through the eyes of the regulated. Rather than taking on board views that are critical of existing arrangements, tame regulators talk only to proponents of the status quo (or people who want even more deregulation). This seems to be what is happening with regard to HFT.

HFT is a big deal – perhaps as much as 70 percent of all stock trades are now done by "black box" computer algorithms (i.e., no one really knows how these work), and there are major open questions whether this operates in a way that is fair for small investors. (Disclosure: in 2000-2001, I was on the [SEC's Advisory Committee on Market Information](#); I was concerned about [closely related issues](#), although market structure has changed a great deal over the past 10 years.)

The technical, "fact-gathering" activities of bodies like the SEC are of critical importance in both building an overall consensus – do we have a problem, what should we do about it – and also in creating the basis for regulatory action (e.g., the SEC does not even collect the data needed to understand how HFT contributed to the May 6 disaster). And anyone who has ever put together a relatively complicated discussion of this nature can attest that how you frame the issues is typically decisive, i.e., what is presented as the range of reasonable alternative views?

On Wednesday, the SEC will hold a "market structure roundtable" to discuss "high frequency trading, undisplayed liquidity, and the appropriate metrics for evaluating market structure performance." But who exactly will be at this discussion?

The names of panelists for this discussion are not yet public and probably not yet final – but the preliminary list is far too much slanted towards proponents of HFT (6 out of 7 seats at the table; see Senator Kaufman's speech for details), with hardly any representation of people in the markets (e.g., "buy side" mutual funds) who think HFT is potentially out of control or unfair. It looks very much like someone is setting up a love fest for HFT – and a boxing match with 6 tough guys against one lonely critic.

To be fair, after coming under heavy pressure from a leading member of the Senate Banking Committee over the past 48 hours, the SEC is backpedaling quickly and indicating that the panel invitations can be broadened. This is encouraging – perhaps the agency is finally overcoming its tin ear problem.

But nothing other than a balanced panel on June 2 would be acceptable. At the very least, the SEC needs to increase the panel to 10 people – 5 for and 5 against. And all the issues need to be on the table – including exactly who benefits from HFT, how much money they make in this fashion, and whether or not long-term investors (and the broader economy) really gain from such arrangements.

The SEC must understand that it has a long way to go to restore its credibility. Wednesday's quasi-hearing is an important test and many people will be watching carefully.

## The Consensus On Big Banks Shifts, But Not At Treasury

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The Baseline Scenario » 2010 » May 5/30/10 at 8:15 AM Simon Johnson

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By Simon Johnson, co-author [13 Bankers: The Wall Street Takeover and The Next Financial Meltdown](#)

Attitudes towards big banks are changing around the world and across the political spectrum. In the UK, the new center-right government is [looking for ways to break them up](#):

“We will take steps to reduce systemic risk in the banking system and will establish an independent commission to investigate the complex issue of separating retail and investment banking in a sustainable way; while recognising that this will take time to get right, the commission will be given an initial time frame of one year to report.”

The European Commission, among others, signals that a [bank tax is coming](#); presumably, as suggested by the IMF, this will have higher rates for bigger banks and for banks with less capital. And other European officials are increasingly worried by the lack of capital in German banks, by the recent reckless lending sprees in Ireland and Spain, and by the dangers posed by banks that are much bigger than their home countries (e.g., Switzerland).

Yet top Obama administration officials refuse to change their opinions in the slightest; they have dug in behind [the idea](#) that they represent the moderate center on banking policy. This is a weak position; it is simply [a myth with no factual basis](#) – the people who pushed effectively for more reform over the past few months were the center, not the left, of the Democratic party.

In the [best profile to date](#) of Tim Geithner, by John Heilemann in *New York Magazine*, even the Treasury Secretary himself expresses frustration with the biggest banks – calling them “the warlords”.

“The irony here was rich, of course, since Geithner’s stabilization scheme would turn out be strikingly favorable to Wall Street. From the outset, his aim was never to punish the banks. Quite the contrary, it was to save them—by pouring money into them, restoring confidence in them, treating them with kid gloves. Nor was his goal to restructure the financial system. It was to prevent the existing system from collapsing and then strengthen the rules governing its operation. In all this, Geithner was betraying the extent to which he shared Wall Street’s mind-set, even if he wasn’t a creature of it. “His office was there and he was deeply enmeshed in that culture and he had those relationships,” says one of his best friends. “That part of the critique is fair.”

David Brooks argued [in the New York Times on Friday](#) – writing about a different industry – that this is unavoidable, and perhaps normal:

“Finally, people in the same field begin to think alike, whether they are in oversight roles or not. The oil industry’s capture of the Minerals Management Service is actually misleading because the agency was so appalling and corrupt. Cognitive capture is more common and harder to detect

More specifically, however, it’s not that “people in the same field begin to think alike”, but rather that “people who are supposed to regulate” begin to see the world through the eyes of the biggest private sector players. Note, for example – and this is important – most hedge fund managers agree big banks are dangerous and will again mismanage risk in a reckless manner.

And cognitive (or cultural) capture, as we argued last year in [The Quiet Coup](#), runs deep in the financial system. Last year [David Brooks rejected our argument](#); it seems the graphic failures of big oil have further shifted the consensus.



Geithner insists that, above all, he represents the reasonable center of responsible opinion,

“I care about us passing [reform legislation] good and strong,” he tells me. “And my feeling is that you have to do this from the center.”

But this is simply not a left-right issue (look at the [blurbs and reviews for 13 Bankers](#)). This is regulatory capture, as laid out by George Stigler from the University of Chicago (a man of the right) – supersized by the increasing gap since 1980 in incomes between the regulated and the regulators (see [Figure 2 in this paper](#), on p.29, by Thomas Ferguson and Robert Johnson).

Mr. Geithner is no closer to a moderate, centrist view on the financial sector than Robert Rubin and Larry Summers were vis-à-vis derivatives (and financial deregulation more broadly) in the 1990s – as documented at length in [13 Bankers](#).

The constraints on size, leverage, and activity of our largest banks could have been much stronger in the Senate bill (and presumably in the final legislation). [Matt Taibbi has a good account](#) of what was (and what could have been) and this is not denied by the administration ([speaking to John Heilemann](#)):

‘If enacted, Brown-Kaufman would have broken up the six biggest banks in America,’ says the senior Treasury official. ‘If we’d been for it, it probably would have happened. But we weren’t, so it didn’t.’

(In case you missed it, Brown-Kaufman was an amendment to the main financial reform bill in the Senate; [more detail here](#).)

The people in charge of our strategy towards big banks are not fools and they are not corrupt; they are also not doing things just because someone on Wall Street calls them up. Our top policymakers are simply convinced that what is good for the biggest and most dangerous element on Wall Street is good for the American economy.

This is [cultural capture](#) in its purest and most extreme form. It increasingly stands out as a problem both in the US context and around the world. Unfortunately, the White House and Treasury may be the last to realize this.

## The Future of Personal Computing, Part 1

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The Baseline Scenario » 2010 » May 5/30/10 at 1:31 PM James Kwak

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*By James Kwak*

This week, [Apple passed Microsoft](#) to become the most valuable technology company in the world (measured by the market value of its stock).<sup>\*</sup> I’ve been wondering about Apple and, in particular, why “apps” — which at first glance struck me as a giant step backward in computing technology — have gotten so much buzz in the media. Then I bought an iPad, and while I understand apps a little better, I’m still perplexed. But since this isn’t a particularly technology-savvy audience, this is going to take some setting up. The background is here in Part 1; Part 2 will be coming shortly.

(Note that here I’m talking about personal computing, which is what people like you and I do on our own; enterprise computing is something very different that [I’ve written about before](#), and still largely takes place on mainframe computers.)

### A Little Background

Rather than recap the entire history of computing ([hilarious synopsis here](#), hat tip [Brad DeLong](#)), I’ll start in the early 1990s. At this point, many people had personal computers, but for the most part they weren’t connected to anything except maybe a printer. (Actually, in the early 1980s my father brought home one of those primitive modems where you actually placed your phone receiver into a socket to communicate, so we could log into the mainframe at his university, but that was the exception.)

A personal computer has an operating system (Windows, OS X, Linux, etc.). This isn’t quite correct, but you can think of the OS as the software that manages the physical parts of a computer: it runs the internal parts, like the CPU and the hard disk drive, and it controls the interface to the parts that you interact with, like the keyboard and the screen. There are also applications that run on a computer (Excel, PhotoShop, Half-Life, etc.). These applications don’t directly manage the physical parts of the computer; instead, they talk to the operating system, which in turn talks to the

physical parts. They do this via the application programming interface, or API, that is published (made accessible) by the operating system.

For our purposes, there are two important features of this structure. First, each operating system has a different API, so you have to write programs differently for each OS. That doesn't mean every line of code has to be different, but the way you call lower-level functions will differ across operating systems. On top of this, each OS developer (Microsoft, Apple, etc.) provides a different set of tools that you use to write programs for its OS. Software developers tend to become better at using one set of tools than another, and hence more likely to write programs for one OS than another.

Second, programs that can access the operating system's API can do a lot of different things to your computer — this is what makes software powerful. At the same time, that means they can do damage to you.

So in the early to mid-1990s, we had self-contained personal computers (Windows or Mac) that ran programs that were written specifically for the operating systems they ran on. (A given program, like Excel, might exist in both Windows and Mac versions, but those were two completely different pieces of software that just looked the same on the outside.) Microsoft dominated this world for a couple of reasons, most importantly that many more programs were being written for Windows than for Mac. I believe this is partly because it was easier to write programs for Windows (Microsoft did a better job providing tools for developers), and partly because the Windows installed base was a lot bigger than the Mac installed base, so a new Windows application had a lot more potential buyers. The Windows installed base was bigger, in turn, because of Microsoft's business model: it licensed Windows to any hardware manufacturer who wanted it, and therefore you had more diversity, more innovation, and lower price points for Windows PCs than for Macs. There were other factors as well, but those are the basics.

## The Internet

Then Tim Berners-Lee gave us the Internet, and Marc Andreessen gave us the browser, and everything changed.

Ever since the mid-1990s, the Internet has played a bigger and bigger role in our daily computing. And so the most important application of all became the Internet browser (Internet Explorer, Netscape, Firefox, Safari, Chrome). This is an application that has the ability to find, display, and interact with resources on the Internet. Like all applications, it talks to the operating system via its API. But it's special in a few respects.

- One is simply that many people spend more time in their browsers than in all their other applications put together.
- Another is that the Internet is largely built around a few basic standards, like HTML (a language that web pages are written in). All browsers have to be able to interpret those standards. So if you build web pages using those standards, you know that all browsers will be able to access them; you don't have to worry about what operating system your visitor's computer is running.\*\*
- A third is that the browser can be designed in such a way as to minimize risk to the computer it is running on. Ordinarily, browsers do not have the ability to modify data on your filesystem. This is for security reasons; the goal is to prevent web sites from automatically launching attacks on your computer. Of course, web sites are constantly asking if you *want* to save files to your computer, and then you're on your own. And there are technologies that can be added to a browser, like ActiveX, that give programs on web sites the ability to get at your hard drive. But in principle, it is harder for a program that lives on a web site and runs inside a browser to do damage than for a program that you install on your computer and that has direct access to the operating system via the API.

The result was the golden age of web-based computing. Around a decade ago, during the Internet boom, the idea became popular in the technology community that all computing would move "to the Web." That is, instead of installing standalone applications that ran on directly on our computers and accessed the operating system's API directly, the interesting software would live on web sites on the Internet, would conform to Internet standards, and would therefore run properly in any browser. This was supposed to have several benefits:

- Computing would be safer, since our computers would be protected by our browsers.\*\*\*
- People wouldn't have to worry about installing and updating software — just about keeping track of their bookmarks.
- Programs would be easier to learn and use for ordinary people, since browsers offer a consistent and intuitive way of interacting with programs.
- We wouldn't have to worry about carrying our data around, backing it up, and syncing it between computers, because it would all be on the Internet.
- Developers would only have to write each program once, because then it would automatically work on all browsers (assuming everyone conformed to standards) and hence on all operating systems.
- As a corollary, the Age of Microsoft would come to an end, since one pillar of its dominance — the huge community of developers writing for Windows — would now be irrelevant.

To some degree, this has happened. I'm writing this post using Firefox at WordPress.com. The computers in my house have three different operating systems and I use three different browsers (Firefox, Safari, and Chrome), which I keep synchronized using XMarks. I spend the vast majority of my computer time in a browser, and not just for consuming information; besides the blog (WordPress), my email, tasks, calendar, and contacts all belong to Google. I try to do most of my lightweight work in Google Documents, I share photos using Flickr, etc. Much of the modern, interactive computing that people do (like Facebook) is done in a browser.

This is, roughly speaking, what Google is all about: a world where the OS and the browser don't matter because they are just tools to get us onto the Internet, where we keep our data and do all our work. It's why Google is writing two operating systems, Android and Chrome, that will both be free, and is developing a suite of Web-based "productivity" applications; they want to cripple Microsoft's business model by giving away their versions of the two things that make Microsoft so profitable: Windows and Office.

Microsoft is still a big, profitable company, because PCs will be around for a long time, most companies use Windows, Office, and other Microsoft products for networking, email, etc., and those products can be very sticky, especially in a corporate environment. But the world is moving away from the 1990s model. Microsoft recognizes this, of course. This is why they fought so hard to crush Netscape in the 1990s — they wanted control of the browser. And it's why they've spent so much money — Hotmail, MSN, .NET, Windows Live, Bing — trying to establish a presence on the Internet. But they just haven't been very good at it.

So at a high level, this is the story of personal computing over the past fifteen years. But recently there has been a new plot twist, which will be subject of Part 2.

\* Great quote by Steve Ballmer in the [New York Times story](#): "Windows phone – boom! We have to deliver devices with our partners this Christmas." Does he realize that he talks like Ari Gold on Entourage?

\*\* This can be thought of as a kind of isolation layer. With Windows, software developers don't need to worry about whether the customer has a Dell, HP, or Acer computer; as long as it has Windows, it will behave in a predictable way. With Internet standards, now you don't need to worry about what OS the customer has, just what browser she has.

\*\*\* Yes, browsers have security flaws, so this isn't a perfect system.

## Regulatory Capture Underground and At Sea

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The Baseline Scenario » 2010 » May 5/30/10 at 11:07 PM James Kwak

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*By James Kwak*

First there was the financial crisis. Then there was the West Virginia mine explosion. Now we have the BP oil leak. In each case, we were treated to news stories about the cozy relationships between the industry and the regulators who were supposed to be regulating it. (Here's the latest [New York Times story](#) on how the Minerals Management Service was captured by industry — a problem that has existed for a long time, but that the Obama administration apparently did little to fix.)

Occasionally people say that the story we tell in [13 Bankers](#) is really the same in every industry. That would not surprise me. I do think that the financial sector is unusual for a couple of reasons. One is that the interconnections between the major financial institutions make each one too big to fail in a way that, say, Enron was not. Another is that modern finance is so complex that it makes it easier for industry lobbyists to run roughshod over congressional opponents. But the problem of regulatory capture is obviously not restricted to finance, and it is a problem that we are seeing all over.

I've been meaning to write about this, but I haven't had and won't have the time. [Arianna Huffington](#) wrote an article on the parallels between the financial crisis and the West Virginia mine disaster. Lawrence Baxter has two recent posts (on his new blog) on [regulatory capture](#) and the [role of regulation](#). Obviously this problem is not easily solved, especially in the wake of the *Citizens United* decision, which gave corporations even more influence over our political life. But hopefully the BP oil leak will produce a wave of anger — and a demand for answers — similar to what the financial crisis gave rise to.

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## The Future of Personal Computing, Part 2

*By James Kwak*

(This is Part 2 of 2; [Part 1](#) covers the shift in personal computing from the age of the standalone PC to the age of cloud computing.)

We left off with the idea that personal computing was inexorably, though slowly shifting toward a Web-based model in which our computers' main purpose is to run browsers and we spend most of our time on the Internet. A decade ago when this idea became popular it was not particularly practical, because you simply couldn't do very interesting things in a browser; it was originally designed, after all, for reading static web pages. But in the past decade, web sites have become much richer and interactive — think about something like Gmail, with its automatic refreshing and keyboard shortcuts, or Google Documents, which allows multiple people to edit a document at the same time — to the point where most of what people do most of the time can be done in a browser.

But then there was Apple.

Apple has a computer business, but there's nothing revolutionary about it. They make very nice, somewhat expensive computers that are structurally basically the same as Windows machines: they have an OS, people write programs that you install on top of that OS (and still not as many people as the ones who write Windows programs), and people with those computers spend more and more of their time using the browser. The increased importance of the Internet as opposed to local (on-computer) applications has probably helped their market share a little, but not that much.

Then there was the iPod, but while it was revolutionary in many ways, it didn't mean much for the course of computing. It's dependent on the existence of a computer running iTunes, which is an ordinary application; the only thing "Internet" about it is that it can access the Internet to buy music.

And then there was the iPhone. The iPhone was a big hit for multiple reasons, like the fact that it was cool, but for our purposes the most important is that it was the first powerful, usable computer in your pocket. Besides email (which it never did as well as a BlackBerry), you can run applications on it that will do virtually anything, since its operating system provides an API that lets developers do pretty much whatever they want.

For most iPhone users, I suspect, what they like about the iPhone is that they can check their email, take photos, and do other things that any smartphone can do. But technology commentators have focused on iPhone's "apps," and Apple has used its app library as a selling point against its competitors.

So what is an app? It's just a plain old application — like the kind we've had on our PCs for decades — except someone figured out that if you drop the last three syllables it sounds new and cool. An app is a piece of software that runs directly on the iPhone OS (a variant of OS X, the operating system on Mac computers), and that you download and buy from Apple's App Store.

If you've followed me to this point of the story, you should realize why I find the app craze so perplexing: it seems like a giant step backward, back to a pre-Internet world where we had to install a bunch of separate applications on our computers, and developers had to write different programs for each operating system. It seems worse than that, even, because with Apple the only place you can get software is from the App Store, which means that Apple gets to decide what can run on your iPhone.

The app model is not entirely pre-Internet, of course. The iPhone and iPad can download apps over the Internet, and those apps can use the Internet as well. But the experience is still that you are switching between a bunch of different applications on your device, as opposed to surfing the web using a browser. You have to find and install those applications, and periodically you have to install updates. Sure there are things that require direct operating system (or hardware) access, like graphics-intensive games, but the thing that confuses me is why people would use apps to do things that they can already do perfectly well in a browser.

This is understandable with the iPhone, because its screen is so small; some iPhone apps just take content on the web and reformat it nicely for the smaller screen. But it makes less sense when you move up to the iPad, which basically has a full-size screen. For example, the New York Times has an iPad app. Buttons across the bottom let you switch between sections (business, sports, etc.), and for each section you have a front page that shows you the beginning of each article, and if you click on an article it takes you to the full content. Very pretty. But I can't think of any reason to prefer it to the Times' web site, which has much more content, and which displays perfectly well on the iPad's browser. This is just one example, but it shows how apps provide a crippled version of what is already on the web. There are other examples, like NPR's app for listening to their radio stories; it's nice, but why not make their web site just as nice, so everyone can benefit from it?

So why apps? The iPad is Apple's attempt to change the way we use computers, away from the PC model and toward a tablet model. And the strategy goes beyond just a new form factor; as we start using tablets, Apple wants us to adopt the app model instead of the Internet model. In particular, Apple is aiming at the category of netbooks — small, light computers whose primary purpose is getting to the Internet (hence the name). It's inevitable that we are going to use smaller computers with touchscreen input; Steve Jobs is right about that. The question is whether we will use them in an Internet-centric way (the way technology was trending over the past decade, and the way Google wants us to use them) or whether we will use them the way Steve Jobs wants us to use them.

Apple prefers the app model for two big reasons. First, it makes their products stickier, since you're not just buying an iPad, you're buying Apple's whole system for delivering stuff onto the iPad. Second, it seems that people are willing to pay for apps while they are unwilling to pay for anything through a browser. So people will pay \$1.99 for an app that plays some game when you can already play the same game for free on a web site somewhere. Maybe people think of apps as standalone objects that have some value and that they can buy, while they see web sites just as destinations that they go to and that should be free. But as long as people will pay for apps, that means that Apple can make money by selling them to you — and by preventing developers from selling them to you directly.

I think it's not too much of a simplification to say that Apple wants to be the new Microsoft. It wants you to buy applications that run locally on your ~~computer~~ iPad, and it sees its competitive advantage as having the most developers and the most applications (hence all those "there's an app for that" ads). As Microsoft showed, if you can get a lead and become the developers' platform of choice, you can benefit from network effects.

This is why the dispute with Adobe is important. For those who don't know, Adobe develops Flash, probably the dominant technology for interactive content on the Internet. The iPhone and iPad don't support Flash, meaning that if you go to a site that needs Flash, you get a big empty box on your screen. (Like, for example, if you daughter wants to visit the [Dinosaur Kids site](#) to play How Big Are You?) This is important because Flash is the most widely used technology to do things on the Internet that *otherwise people would buy apps for*. You can think of it as a small attempt to cripple the Internet (for people using an iPhone or iPad) to force them toward the App Store (for games) or the iTunes Store (for video).

(Even the iPad's browser — a version of Safari — has trouble with some rich interactive web sites; for example, I can't figure out how to edit Google Documents on the iPad. This is probably simply due to the tradeoffs Apple had to live with in order to make the browser work with the iPad's modest specs, but it has the side effect of slightly crippling the Internet and forcing you toward apps.)

But the Apple-Adobe dispute goes further. In April, Apple [changed the terms](#) of the iPhone developer agreement to prevent developers from using cross-compilers to create iPhone apps. A cross-compiler is a tool that allows you to take an application you wrote for one platform, push a button, and repackage the application for another platform (in this case, iPhone OS). The immediate target of this was Adobe, which was developing a tool that would enable developers to take Flash apps, push a button, and make them into iPhone apps. This simplest explanation for this is that Apple, as the market leader, wants to make it *harder* for people to develop for multiple platforms at the same time. "Write once, run anywhere" — the slogan of Java, but also the essence of developing for the web — is *bad* for Apple, and they want to make it as hard as possible. ([John Gruber](#) makes a different argument that Apple wants control over their platform and doesn't want cross-compilers between it and the developers, but that interpretation is not inconsistent with mine.) In other words, if you're number one, then openness just helps the competition, because if developers have to choose just one platform, they're going to choose yours.

So Apple is competitive; we knew that already. And they don't want to repeat the mistakes of the 1980s and 1990s; we knew that already, too. But I think the important point is that they are promoting a model of personal computing where most of the developers write for the iPhone OS, and if you want to use their applications you have to buy an Apple hardware product. Yes, Apple makes great hardware, but I think consumers will do better with an open model; if you look at smartphones, it's already the case that many phones running Android — Google's open-source operating system — are better than the iPhone at many different things. (The iPhone may still be the best overall, but there are many good reasons why you might pick a particular Android phone over the iPhone.) And Android has already [passed the iPhone](#) as the number two smartphone (measured by new sales), behind the BlackBerry.

Conceptually, I still think the best thing for consumers is a model that is open on every level: web-based development, so that content and functionality are available at the same time for anyone using any browser, allowing competition among operating systems and, for a given operating system, between different hardware manufacturers. With personal computers, Microsoft established a monopoly on the OS level, which made Windows the least common denominator of everyone's computing experience. Now Apple wants to lock people into their hardware and OS and create an ecosystem of developers, applications, and content that you can only get through Apple.

The obvious alternative is Google, which has its own operating systems (Android and Chrome), but doesn't particularly care if you use them or not — as long as you are using the Internet, where they sell their ads. I'd like to see an Android

tablet with a real browser that can handle anything on the Web, and then I simply wouldn't need most of the apps I have on my iPad (Calendar, Contacts, Notes, Maps, AccuWeather, Netflix, NPR, Bloomberg, etc.). Now, Google isn't pursuing an open strategy because it's nice; they're doing it because they want everyone to go to the Internet to see their ads. But ultimately I think that's a better model for consumers, because you avoid lock-in on the development level (developers don't have to commit to the iPhone OS) and on the hardware level (anyone can build an Android device, which is already providing more innovation and choice when it comes to smartphones).

So while I like Apple products, I have no particular wish to see them win the technology war, at least not with their current strategy.

## Summer "Vacation"

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The Baseline Scenario » 2010 » May 5/31/10 at 11:00 AM James Kwak

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*By James Kwak*

Tomorrow I am beginning my summer internship (for those who don't know, I'm a law student between my second and third years). I'm going to be working in death penalty defense.

Sometimes people ask me how I find the time to write this blog. The answer is that being a student at the Yale Law School takes a good deal less time than a real job. (You can, of course, make yourself very busy with clinics, journals, and other activities, but you don't have to.) But this summer will be like a real job, and I intend to spend the time that I'm not working with my family, which means that I will be cutting way, way back on blogging this summer. I'm guessing that I'll write about two posts per week, but I would not be too surprised if I don't even manage that, and there's a small chance I won't have time for anything at all.

I expect that I'll get back to something close to my usual frequency in late August or early September.

Thank you for taking the time to read the blog.