

Eugene Fama: “Too Big To Fail” Perverts Activities and Incentives

The Baseline Scenario » 2010 » June 6/2/10 at 6:07 AM Simon Johnson

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

In our continuing financial debate, one of the central myths – put about by big banks and also not seriously disputed by the administration – is that reigning in “too big to fail” banks is in some sense an “anti-market” approach.

Speaking on CNBC at the end last week, [Gene Fama](#) – probably one of the most pro-market economists left standing – pointed out that this view is nonsense. (The [clip is here](#), and also on [Greg Mankiw’s blog](#); TBTF is the focus from about the 5:50 minute mark.)

Having banks that are Too Big To Fail, according to Fama, is “perverting activities and incentives” in financial markets – giving big financial firms,

“a license to increase risk; where the taxpayers will bear the downside and firms will bear the upside.”

Fama is not backing down from any of his previous strong pro-market views – as explained by [John Cassidy in the New Yorker recently](#) (the [full article on the Chicago school](#) is also good, but requires a subscription) – and we can argue about his views on the functioning of financial markets or capitalism more broadly. When everyone is opportunistic and the “rules of the game” themselves are up for grabs – for example through lobbying based on existing and expected future super-profits (e.g., from being allowed to exercise any form of monopoly) – then bizarre and bad things can happen.

But, in any case, Fama is completely correct that,

“[Too Big To Fail] is not capitalism. Capitalism says – you perform poorly, you fail.”

He is also correct that “complicated regulation may be a nice idea in principle

but in practice it never works”. Regulators get captured by the people they are supposed to be regulating (as now illustrated in the oil and gas industry); this is “not unusual; it happens all the time”.

Fama has obviously considered just letting big banks fail (“I would have been for that all along”), but he recognizes that this cannot work in our political realities – governments will step in and make bail for banks when there is serious trouble. And, as Senator Ted Kaufman pointed out [in his exchange with Senator Mitch McConnell](#), allowing the collapse of huge banks is a recipe for turning crisis into catastrophe.

Fama argues “the only solution is to raise capital requirements of these firms dramatically,” maybe up to 40-50 percent, which is [an idea we have also advanced](#). It’s an interesting question whether this by itself would take the failure of mega-banks completely off the table – that would probably depend on the extent to which they were allowed to game the system, for example with risk taken through derivative positions against which they hold too little capital.

Still, Fama is thinking along exactly the right lines – and this is further confirmation that [the consensus on big banks is shifting](#).

If implemented properly, capital requirements of the kind he proposes would essentially force the largest six or so banks today to become much smaller. Given that capital requirements are set by regulators, who claim to be pro-market, they should take careful note of Fama’s views – and look for ways to implement a tough version of this approach.

The Maginot Line Illusion

The Baseline Scenario » 2010 » June 6/3/10 at 6:16 AM Simon Johnson

By Peter Boone and Simon Johnson

Many commentators suggest Spain is now the euro zone’s [Maginot line](#). The

argument is clear: Spain, with GDP over \$1.3 trillion (8th largest in the world; 5th largest in Europe) and its large outstanding bank and public debt, is simply too big to fail without causing irreparable harm to the euro zone financial system. If we dig in here, the reasoning goes, eurozone market upheavals can be stopped.

Just as Germany did in 1940, in past weeks global market forces circumvented this new Maginot line without serious resistance. The events that shook equity markets were not just in Spain; they were everywhere in the world. The cost of protecting against default on India's largest private bank rose 79BP, or 44%, and the cost of protecting against major Korean banks' default similarly rose 45%. Oil prices collapsed and emerging markets found their access to credit markets dried up. The interest rate for lending between banks in US dollars (LIBOR) shot up, and investors piled funds into their currently perceived "safe-havens" driving down the yields of German, French, and US bonds.

This pattern reflects the core problem facing world markets today. Investors have already begun to extrapolate from eurozone problems to understand that the world remains a highly dangerous place. The latent dangers include our overreliance on rapid Asian growth that might falter, the pressure for sharp fiscal tightening in nations with high deficits (other than in the world's "safe havens"), and highly leveraged banks that continue to own toxic real estate, weak sovereign debt, and other assets. If world financial markets once again decide their risk appetite is again low, there are many unsustainable leveraged institutions and governments that are in for a tough ride.

Spain's role in this possible calamity is more that of a sideshow than a frontline. Spain has a fighting chance for survival without serious economic disruption, but only if the world economy remains at the least benign. To get out of its difficulties, the Spanish government needs to be far more determined than the light approach taken by the Irish and Portuguese (which face far worse problems than Spain).

To be clear, Spain has a better chance of avoiding sovereign and massive bank defaults compared to Greece, which is in intensive care – with a doubtful prognosis and a permanent resource infusion from the European Central Bank. In this regard the announcements in the last few weeks from Spain were helpful,

for example when the government chose resolution authority over religious authority in taking legal [control of a troubled savings bank \(CajaSur\) from the Catholic Church](#).

Spain's savings banks, often owned by local authorities, the church, and other civic groups are generally a bastion of moral hazard due to the implicit belief that no political leader would let the relevant creditors fail. The CajaSur takeover did not impose losses on creditors, but it did establish that the managers of failed banks can at least lose their jobs.

The highly unpopular budget reforms announced by Prime Minister Zapatero further demonstrate some resolve – and the fact they just passed a legislative hurdle is encouraging. According to optimistic forecasts, Spain's budget deficit will fall to 5.3% of GDP next year (although the [European Commission still has this projected at 9.8%](#)). If Spain can get anywhere near this level, despite 20% unemployment, then financial markets will probably go easy on them. Spain's high unemployment is partly the result of a more liberalized labor market that made it easier for employers not to renew term contracts. This has made Spain one of the worst nations in Europe in terms of employment loss, but it also means jobs could rebound quickly.

So the question is not whether Spain can remain solvent, but rather whether world markets will be patient enough – and risk tolerant enough – for a much wider range of nations to have enough time to make the needed adjustments.

The Achilles heel for Spain, and for others in Europe, are private credit markets – loose banking regulations and (in some countries) lax fiscal policy during the boom of the 2000s have placed serious countries at the mercy of bond markets. We now know the European Central Bank will refinance sovereign debt for a long time, but there are 22 trillion euros of credits provided by the euro zone banking system largely to the private sector (with total eurozone GDP around 9 trillion euros, this makes euroland highly dependent on credit). If the banking system decides it needs to tighten up on risk-taking, some of this credit will be cut off – thus further slowing growth in the region.

The first and greatest cuts under such a scenario would be for debtors in

Portugal-Ireland-Italy-Greece-and-Spain (still lumped together by markets). There are 2 trillion euros of external private credits to Spain, Greece, and Portugal alone – any modest attempt to contract this amount will set off a new round of lower asset prices as enterprises and households try to sell off what they can in order to repay loans, while banks march in to foreclose on property and cut their exposures.

In the United States such a credit contraction would be met with the Federal Reserve pouring out liquidity and helping bail out many creditors. This would not solve the underlying problem – and stores up serious moral hazard issues for creditors in the future – but it at least gives time for the debtors to make payments. The US will also remain a safe haven, as least for a while, and that gives a cushion for the government to run budget deficits and avoid fiscal cuts driven by nervous bond markets.

For Europe it is much harder to predict how events will evolve over the same time frame. The recently announced 750bn euro package actually implies that the troubled nations (definitely Greece and Ireland, likely Portugal and perhaps Spain) must make large fiscal cuts. Bond market vigilantes reign supreme if their actions force fiscal cuts – sadly, this is where the eurozone periphery finds itself. At the moment Germany and France are the safe havens. Bond yields in France fell sharply the last two weeks, while Spain's yields rose, and would have increased much more were it not for ECB purchases.

But who is really safe in Europe? [With France running](#) an 8% GDP budget deficit (for 2010) and a [debt/GDP ratio of 83.6%](#), should we be confident they are safe while Spain is not (with [debt/GDP at 65%](#))? France's thirty years of budget deficits do not bode well for anyone expecting an immediate strong fiscal response. In many ways Spain appears better placed to take tough actions than France.

If investors decide that risk taking is no longer the right mode, many nations will be in trouble; there may be Maginot Lines but they are worth nothing. If recent market sentiment signals a coming global downturn rather than continued world growth, investors will soon question whether even the safest havens are safe.

An edited version of this article [appeared today](#) 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.

French Connection: The Eurozone Crisis Worsens Sharply

The Baseline Scenario » 2010 » June 6/4/10 at 12:57 PM Simon Johnson

By Peter Boone and Simon Johnson

The big news is France. With sentiment worsening across Europe, France has lost its relative safe haven status – credit default swap spreads on French government debt were up sharply today.

The trigger – oddly enough – was [Hungary's announcement that its budget](#) is worse than expected (blaming the previous government; this is starting to become the European pattern) and in the current fragile environment [discussed yesterday](#), this relatively small piece of news spooked investors. But these developments only reinforced a trend that was already in place.

It did not help that the Irish Minister of Finance announced Ireland has 74.2bn euros of guaranteed bank loans, bonds, and systemic support falling due between now and Oct 1. This is around 55% of GNP. It sounds like everyone backed by the Irish government had the “clever” idea to roll over their debts to just before the guarantees expire.

The big losers are Portugal-Ireland-Italy-Greece-and-Spain as always, but Belgium is now in the line of fire, and France is clearly under pressure. The spread between French and German credit default swaps (measuring the relative probability of default) is up – yesterday this was 40 basis points, today it stands at 44 (up from just 5 basis points at the end of 2009; most of the increase is since mid-March, with a sharp acceleration recently). French bonds have become illiquid, with wide bid-ask spreads; not what is supposed to happen in a safe haven. This is going to make the French angry – watch for more market

slanders from top French politicians over the weekend; you know they would just love to ban trading in something.

Earlier today the French Prime Minister came out with a quote for the ages:

“I only see good news in parity between euro and dollar”.

Be careful what you wish for – such statements will drive the Germans crazy as they see further evidence that inflation lovers are clearly winning influence and might just gain control at the European Central Bank (ECB).

This has the potential to become a run on most non-German bonds in the euro zone. Next we will see pension funds and reserve managers stepping back and waiting to see what happens – there is no profit in buying French bonds for a 40 basis point spread over Germany given the risks and illiquidity that we have seen in other markets.

The eurozone leadership may be tempted to address the short-term issues by providing much greater Quantitative Easing (i.e., putting a lot more money into circulation through buying government bonds) than the ECB has already promised. However, the ECB does not have the fiscal backing necessary to take that sort of sovereign risk, as this is ultimately a mix of a bank run and serious private and public sector solvency problems.

These solvency problems will worsen as they are allowed to fester. And if the ECB announces it will buy French bonds, investors will probably step further back and just let them buy. We are beyond the point where mere expressions of intent-to-support will lead to a private sector rally.

Investors increasingly fear that it is simply unsustainable – economically and politically – for the ECB to support the rollover of public and private debts. If investors – acting on this belief – refuse to rollover bonds, the entire policy disintegrates into uncontrolled money issue. Quantitative Easing on this basis will fail.

The ECB is going to be forced to show a deeper hand, potentially along three

dimensions.

First – the euro authorities have to let the euro truly collapse, e.g., below parity with the US dollar. This reduces solvency issues across the eurozone. Ironically, by doing nothing, and bickering within Europe as Rome (and Madrid and even Paris) burn, this is one measure that Europe seems set on delivering.

Second – if the euro devaluation does not come fast enough (or does not promise enough immediate future growth), the ECB and others will push for a “Plan B” within which at least some of the weaker eurozone countries implement “voluntary” debt restructurings (of the kind more common and not necessarily so traumatic in emerging markets; see Kazakhstan) – in which they make offers to bondholders to restructure and threaten to default if they are not accepted.

This will end rollover risk among these sovereigns – particularly as the banks will be forced to follow suit. European bank regulators need to work with each major European bank to ensure it is adequately capitalized post-restructuring. This is a good time to change management/directors and look at imposing losses on at least some unsecured creditors, although the fear at such moments is always that systemic panic will set in; vulnerable financial structures induce bailouts (and future moral hazard, as [President Obama can attest](#)). The ECB will need to provide liquidity to prevent bank runs.

Third – the eurozone nations that remain without a restructuring will need G20 support to roll over their public debts while rolling over or – failing that – restructuring some private financial sector debts. This includes France.

Progress on steps 2 and 3 require consensus within Europe and determined actions with international support. This remains nearly impossible until nations face the obvious risk of national financial collapse.

We are not there yet but this is the dangerous glide path. As the bond market moves towards a buyers strike and with Europe’s leaders doing nothing – simply hoping all their problems will melt away by themselves – the path of least resistance is to spiral downward.

Pressure from other governments will quickly mount and offers of international help will appear without any difficulty. The G20 will soon be desperate, again, to get Europe to seriously sort itself out.

And think of the diplomatic coups that await China when it figures out how to throw its more than \$2 trillion of reserves into the fray.

Surely the White House finally understands what is going on – they must lift their heads from the compelling tragedy of the Gulf coast and determine whether American global economic leadership rises or falls.

Update (revised): the exact quote from the French PM is “Je n’ai pas d’inquiétude quant à l’actuelle parité entre l’euro et le dollar”. ~~He may be referring to the current euro-dollar rate but there is some potential ambiguity here.~~ Saying this on a day when the euro is collapsing, he is clearly condoning further collapse.

Richard Fisher (Federal Reserve Bank Of Dallas): Larry Summers, The G20, And Financial Dementia

The Baseline Scenario » 2010 » June 6/6/10 at 8:42 PM Simon Johnson

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

Richard Fisher, president of the Dallas Fed, has long been a proponent of serious financial sector reform. As a former commercial banker, he sees quite clearly that the legislation now headed into “reconciliation” between House and Senate versions amounts to very little. He also knows that pounding away repeatedly on this theme is the best way to influence his colleagues within the Fed and across the policy community more broadly.

He is now [taking his game to a new, higher level](#). Couched in the diplomatic language of senior officials, [his speech on June 3](#) to the SW Graduate School of

Banking was both a carefully calibrated assault on the administration's general "softly, softly" approach to the big banks and a direct refutation of arguments put forward by Larry Summers in particular.

As the title of Mr. Fisher's speech implies, if the legislation is not real financial reform (and it is not, according to him), then our current policy trajectory amounts to facilitating further rounds of financial dementia.

As a statement of our true problems – dismissing the red herrings and focusing on the core issues – Mr. Fisher's speech is a succinct classic. Cutting to the chase:

"Regulators have, for the most part, tiptoed around these larger institutions [big banks]. Despite the damage they did, failing big banks were allowed to lumber on, with government support. It should come as no surprise that the industry is unfortunately evolving toward larger and larger bank size with financial resources concentrated in fewer and fewer hands."

This is most definitely not a market outcome.

"Based on these considerations, coupled with studies suggesting severe limits to economies of scale in banking, it seems that mostly as a result of public policy—and not the competitive marketplace—ever larger banks have come to dominate the financial landscape. And, absent fundamental reform, they will continue to do so. As a result of public policy, big banks have become indestructible. And as a result of public policy, the industrial organization of banking is slanted toward bigness."

This is an unfair, nontransparent, and dangerous taxpayer subsidy at work.

"Big banks that took on high risks and generated unsustainable losses received a public benefit: TBTF ["too big to fail"] support. As a result, more conservative banks were denied the market share that would have been theirs if mismanaged big banks had been allowed to go out of business. In essence, conservative banks faced publicly backed competition."

Mr. Fisher is agreeing with arguments sometimes heard from the left of the political spectrum, but he is most definitely coming at this more from what is traditionally – and accurately – regarded as the right (like Gene Fama of Chicago or Tom Hoenig of the Kansas City Fed).

“It is my view that, by propping up deeply troubled big banks, authorities have eroded market discipline in the financial system.”

In this context, attempts to regulate big banks more effectively will fail because the underlying political economy dynamic (i.e., how the creditors understand government policy towards big banks) encourages excessive risk-taking and greater leverage one way or another.

“The system has become slanted not only toward bigness but also high risk. Consider regulators’ efforts to impose capital requirements on big banks. Clearly, if the central bank and regulators view any losses to big bank creditors as systemically disruptive, big bank debt will effectively reign on high in the capital structure. Big banks would love leverage even more, making regulatory attempts to mandate lower leverage in boom times all the more difficult. In this manner, high risk taking by big banks has been rewarded, and conservatism at smaller institutions has been penalized.

Indeed, large banks have been so bold as to claim that the complex constructs used to avoid capital requirements are just an example of the free market’s invisible hand at work. Left unmentioned is the fact that the banking market is not at all free when big banks are not free to fail.”

Add to this the deference of the US Treasury to the international negotiations on capital requirements, and the manifest problems of the G20 in this regard – held to the lowest common denominator again over the weekend (i.e., no mention of capital requirements or other substantive re-regulation [in the communiqué](#)). Fisher’s assessment is right on target: relying on regulation alone is unwise and most definitely the triumph of hope over experience.

“Regulatory reform discussions portray the need to control systemic risk as a new game in town—as if it were a new responsibility that need only be assigned. This is not the case: Bank regulators have long viewed the

containment of systemic risk as a primary rationale for capital requirements. The problem is that capital regulation has rarely been truly successful.”

“... While we do not have many examples of effective regulation of large, complex banks operating in competitive markets, we have numerous examples of regulatory *failure* with large, complex banks. “

And just saying, “let ‘em fail”, is also quite unrealistic as policy for megabanks – because this has been proven, time and again, not to be “time consistent”, i.e., you can promise to do this all you want, but:

“We know from intuition and experience that any financial institution deemed TBTF will not be allowed to fail in the traditional sense. When such an institution becomes troubled, its creditors are protected in the name of market stability. The TBTF problem is exacerbated if the central bank and regulators view wiping out big bank shareholders as too disruptive, extending this measure of protection to ordinary equity holders.”

“... Even a combination of enhanced regulation and resolution would likely be inadequate. The temptation to use regulatory discretion to avoid disruptions is just too great.”

But Mr. Fisher is most devastating when it takes on the arguments developed by Larry Summers (and used by many Senators) against imposing binding size caps on the largest banks.

Larry Summers, you may recall, argued that “most observers” agree that breaking up big banks would actually make the financial system more risky. It turns out that “most observers” are actually just a few commentators – with what Fisher assesses as “hollow” arguments. For example, on the idea that smaller banks would all copy each other and follow identical high-risk strategies,

“... going by what we see today, there is considerable diversity in strategy and performance among banks that are not TBTF. Looking at commercial banks with assets under \$10 billion, over 200 failed in the past few years, and as we have seen, failures in the hundreds make the news. Less

appreciated, though, is the fact that while 200 banks failed, some 7,000 community banks did not. Banks that are not TBTF appear to have succumbed less to the herd-like mentality that brought their larger peers to their knees.”

And reference to the banking problems of the 1930s is simply not relevant.

“Such a liquidity crisis among small banks would be unlikely today, as we now have federal deposit insurance, which protects deposits for funding. And, I might add, the Federal Reserve has demonstrated quite effectively over the past two years that we not only have the capacity to deal with liquidity disruptions but also the ability to unwind emergency liquidity facilities when they are no longer needed.”

Overall, Fisher is blunt.

“...sufficient or not, ending the existence of TBTF institutions is certainly a necessary part of any regulatory reform effort that could succeed in creating a stable financial system. It is the most sound response of all. The dangers posed by institutions deemed TBTF far exceed any purported benefits. Their existence creates incentives that will eventually undermine financial stability. If we are to neutralize the problem, we must force these institutions to reduce their size.”

This is most definitely not a retreat to some financial stone age.

“A globalized, interconnected marketplace needs large financial institutions. What it does not need, in my view, are a few gargantuan institutions capable of bringing down the very system they claim to serve.”

And, he points out, if his fellow regulators could only think clearly about this issue, there is hope.

“...the financial regulatory reform bill has left regulators (specifically, the Board of Governors and the Federal Deposit Insurance Corp.) with the authority to impose greater restrictions on firms whose living wills are not

credible. That authority, as I mentioned previously, could include “[divesting] certain assets or operations ... to facilitate an orderly resolution.” I would argue that regulators should freely use this broad authority to commit credibly to resolution with creditor losses by reducing big banks’ size and interconnectedness.”

Sadly, the indications are that too few officials are likely to agree with Mr. Fisher any time soon.

Orientation

The Baseline Scenario » 2010 » June 6/7/10 at 9:11 AM James Kwak

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Want more? Read [13 Bankers: The Wall Street Takeover and the Next Financial Meltdown](#).

Investment Banks and the World Cup

The Baseline Scenario » 2010 » June 6/8/10 at 11:17 AM James Kwak

By James Kwak

A reader alerted me to the [World Cup forecasting competition](#), which includes links to the predictions made by several major [investment banks’ models](#), and some [data](#) you can use if you want to give it a shot. The predictions:

- JPMorgan Chase: England
- UBS: Brazil (UBS also has South Africa as the team most likely to make the second round, which seems surprising.)

- Goldman: Brazil
- Danske Bank: Brazil

I typically root for France, because I started following soccer while living in France back in the early 1990s, but I don't think I can this time because (a) they don't deserve to be in the World Cup Finals, having beaten Ireland on an obvious hand ball and (b) I can't stand their coach, who has managed to transform an incredibly talented group of players into a mediocre team.

As for who will win, I would go with [Nate Silver](#) (who recently [signed with the Times](#) for three years) if he made a prediction, but I don't think he has.

Enjoy.

The Perils of Studying Economics

The Baseline Scenario » 2010 » June 6/8/10 at 11:51 AM James Kwak

By James Kwak

[Patrick McGeehan](#) at the New York Times recently wrote about a [New York Fed study](#) finding that studying economics makes you a Republican. The headline conclusion is that the more economics classes you take, the more likely you are to be a Republican. Majoring in economics or business is also more likely to make you a Republican. (See Table 2 in the original paper.) The study is based on thousands of observations of undergraduates at four large universities over three decades, so it is focused on undergraduate-level economics.

Studying economics also affects your position on several public policy issues. Of seven issues, economics courses were significantly associated with the five following positions (Table 6):

- Tariffs are bad.
- Trade deficits are not so bad.

- The government should not cap oil prices in response to a supply shock.
- Raising the minimum wage increase unemployment for low-wage workers.
- Income distribution should not be more equal.

These are all pro-free market, anti-government intervention positions.

What I thought was particularly interesting, however, was that on some issues people who study undergraduate economics are *more doctrinaire* free marketers than professional economists. Table 5 compares the undergraduates responses to those of a survey of people with a Ph.D. in economics. The Ph.D. economists were more likely than economics majors to hold the textbook position on tariffs or the minimum wage. However, they were also more likely than economics majors (or, frankly, any majors) to think that income inequality should be reduced and that government spending should *not* be reduced, and they were somewhat less worried about federal budget deficits.

This is something I've mentioned in passing often. I think that basic economics, the way it is taught today, tends to give people reflexive pro-free market, anti-government positions — positions that are *not* held by people with a deeper exposure to economic thinking. When your understanding of government finances is based on reading the newspaper, it's somewhat eye-opening to come to college and learn that free markets lead to maximum societal welfare and taxes impose a deadweight loss on society — the pictures are so simple and compelling. That's why a little bit of economics makes you more likely to be a Republican.

But when you learn more about principal-agent problems, information asymmetries, and so on, you learn that those simple pictures are simplistic to the point of being misleading. That's why Joseph Stiglitz argues in *Freefall* that understanding economics is crucial to understanding why free markets often lead to suboptimal outcomes. The problem isn't knowledge per se; it's a little bit of knowledge.

Can the Buy Side Take on the Sell Side?

By James Kwak

[*The Economist*](#) did not like [*13 Bankers*](#): “A broader perspective would have led to more nuanced conclusions. The origins of America’s financial ‘oligarchy’, for instance, might have more to do with campaign-finance rules and political appointees than banks’ size. The faith that Messrs Johnson and Kwak put in merely capping the size of banks is misplaced.”*

But a reader pointed us to the Economist columnist who goes by the name of Buttonwood (the site of the founding of the New York Stock Exchange), who seems a bit more favorable. In a recent column criticizing the rent-seeking of the financial sector, Buttonwood seems to tell broadly the same story:

“Something has clearly changed within the past 40 years. Banking and asset management used to be perceived as fairly dull jobs, which did not attract a significant wage premium. But after 1980, financial wages started to climb much more quickly than those of engineers, another profession that ought to have benefited from technological complexity.

“Around the same time, banks became more profitable.”

He even nods toward breaking up the banks:

“At the moment, governments are wading in with all kinds of levies and regulations, which will probably have unintended consequences. Rather than tackle the big problem (for example, by breaking up the banks), they waste their time on populist measures like banning short-selling.”

In the end, though, Buttonwood endorses a different solution: getting the buy side (investment funds) to take a stand against the sell side (investment banks):

“Paul Woolley . . . has published a manifesto which he believes should be adopted by the world’s biggest public, pension and charitable investment

funds. Among other things, he proposes that the funds should adopt a long-term investment approach, cap annual portfolio turnover at 30%, refuse to pay performance fees or invest in alternative assets such as hedge funds and private equity, and invest only in securities traded on a public exchange.”

In other words, the buy side should realize that its getting screwed by the sell side and start looking after its own interests.

I would love it if this were to work. But I’m not optimistic. Because while the institutions that make up the buy side and the sell side have different economic interests, they are populated by the same set of people who believe the same things. Pension fund managers are not suddenly going to acknowledge that they can’t beat the market in the short term and shift to low-turnover, long-term investing, because that would undermine their own claim on a piece of the action. You become a manager of a big fund by beating the market, and you beat the market by taking on extra risk and getting lucky. You’re willing to put money into fancy hedge funds and private equity funds because *it’s not your money*, so you get a chunk of the upside (a better job, more funds to manage, more money) and none of the downside (no one will blame you for putting money into Goldman’s hedge fund, even if it doesn’t do well). The people whose retirements depend on the pension fund’s returns have one set of interests. But the people managing that fund very often have another.

* For the record, we did discuss both campaign finance and especially the problem of political appointees who are friendly to Wall Street at some length — a lot of Chapter 4 and a chunk of Chapter 6.

Decision Time: Has the President Abandoned Paul Volcker’s Ideas On Financial Reform?

The Baseline Scenario » 2010 » June 6/10/10 at 6:10 AM Simon Johnson

By Simon Johnson

The official reconciliation process between Senate and House reform bills will get underway next week, but the behind-the-scenes maneuvering (and intense lobbying) is already well underway. The main remaining question is whether the final legislation will ultimately make the financial system at all safer than it was in the run up to the crisis of September 2008.

How do big banks repeatedly get themselves into so much trouble? Dangerous banking in today's world involves banks trading securities and, in that context, taking positions – i.e., betting their own capital. For example, almost [all the profits made by big banks in 2009 came from securities trading](#). When market conditions are favorable and traders get lucky, the people running these banks (and hopefully their shareholders) get tremendous upside. But when this same risk-taking behavior results in big losses, the major negative impact is felt in terms of a major recession, raising government debt, and sharply lower employment.

“Wall Street gets the upside, and society gets the downside” is an old saying that is now more relevant than ever. This asymmetry in incentives explains how smart people with concentrated financial power can cause so much damage – according to, for example, the [Bank of England's analysis](#).

The derivatives market is the arena where much of this risk-taking activity occurs. And while the financial regulatory reform bill makes some efforts to bring the derivatives market onto exchanges – although the exemptions granted are far too sweeping – it does disappointingly little to separate out risky trading from critical banking infrastructure, i.e., the payments system and relatively boring parts of traditional retail and commercial banking without which any modern economy cannot operate.

An earlier version of this risky-boring split is exactly what inspired the [Glass-Steagall legislation of the 1930s](#) and, while these specific arrangements had drawbacks and ultimately broke down, they did serve the US economy well for close to 50 years. (We review exactly what happened to Glass Steagall and why in [13 Bankers](#).)

The spirit of the reforms advocated by Paul Volcker – and championed, at least

in principle, by the administration – is to update and apply the principles behind Glass-Steagall (links to more details: Volcker’s [original policy push](#) and [his current thinking](#)). We need to separate the relatively high risk parts of banking from the relatively boring and safer parts that are essential to the payments system and to the routine credit needs of households and business.

There are two provisions that are currently under consideration for the “reconciliation” between Senate and House versions of regulatory reform that seek to address this problem, and while each is valuable, they come at the problem from different directions.

[Senator Blanche Lincoln’s approach](#) – which focuses exclusively on derivatives trading (the purview of the Agriculture Committee, which she chairs) – would require banks to set up separate subsidiaries, within which they would need to hold a great deal more capital against their trading books. In this way, the Lincoln approach addresses all derivatives trading, including the use of proprietary capital.

The “Lincoln amendment” would have real teeth and – if properly implemented by regulators – would make derivatives trading substantially less risky. It would also make such trading less profitable – requiring more capital to be held against downside losses will also reduce the extent of upside profits; this is a feature, not a bug. Big Wall Street banks are naturally furious and fighting hard – with all the lobbying power and potential campaign contributions at their disposal to ensure that profits prevail over social considerations (that’s their job, after all). Unfortunately, all the indications are that the megabanks will prevail and the Lincoln amendment will be completely stripped from the final bill.

Senators Jeff Merkley and Carl Levin would go [a considerable distance in the same direction](#), although with greater focus on separating out – and not allowing, if regulators follow through – the “proprietary” (own capital) bets that recently crippled even the biggest banks. Remember that Bear Stearns and Lehman were broken by their holdings of toxic real estate-related assets, while Citigroup, Bank of America and others were brought low by wrongly believing that certain kinds of derivatives were good bets.

The Merkley-Levin approach leaves client-focused trading (buying and selling securities for others) where it is now within the big banks, but it would exclude the inappropriate use of proprietary capital across all types of financial instruments – not just derivatives. The Merkley-Levin amendment gathered great momentum in the Senate and would almost certainly have prevailed in a floor vote – but through some unpleasant parliamentary maneuvering (at the instigation of the banking lobby, presumably), [it was denied such a vote](#).

Within the reconciliation process, Merkley-Levin still has a chance, although the precise odds depend on how hard the White House wants to fight. The president announced the Volcker Rules to great acclaim in late January, but unfortunately the detailed follow up by [his own team was lackluster at best](#). Senators Merkley and Levin stepped into the political and legislative gap, pushing hard for at least some version of the Volcker principles to be adopted in Senator Dodd's bill.

They were turned back at every stage, but have remained doggedly on message. Ultimately, this comes down to President Obama. Is he will to really put his political capital seriously into play? Or is his new found (and oil spill inspired) rhetoric against runaway corporate power and pathetic regulation at best completely empty and at worst a smokescreen for continued abuses?

We will learn a great deal in the coming weeks, not just about the future stability of our financial system, but also for what President Obama really stands.

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

Why Section 716 is the Indispensable Reform

The Baseline Scenario » 2010 » June 6/10/10 at 9:30 PM James Kwak

By Jane D'Arista

This guest post is contributed by Jane D'Arista, a research associate at the Political Economy Research Institute at the University of Massachusetts, Amherst, and co-coordinator of its Economists' Committee for Stable, Accountable, Fair, and Efficient Financial Reform (SAFER). She has taught in graduate economics programs at several universities and served on committee staffs of the U.S. House of Representatives.

Dominated by the world's largest banks, the over-the-counter (OTC) derivatives market has been expanding since the break-down of the Bretton Woods Agreement in the early 1970s privatized the international monetary system by shifting the payments process from central banks to commercial banks. The proliferation of foreign exchange forwards and swaps that followed set in motion an ever-expanding menu of exotic instruments that reached a nominal value of over \$600 trillion by the middle of the current decade. Central banks and financial regulators ignored the implications of the growth of this market and ignored warnings from the Bank for International Settlements (BIS) and the International Monetary Fund (IMF) from 2002 forward that OTC derivatives were at the center of what had become a global casino in which the largest international institutions were the biggest speculators.

The large, international institutions that created the OTC market for foreign exchange forwards and swaps were commercial banks. Following established banking practice, they conducted their derivatives business like portfolio lenders rather than broker/dealers, buying and selling forwards and swaps outside of established markets. But OTC derivatives contracts can't be classified as assets or liabilities until they are settled and can't be held on banks' balance sheets the way loans and deposits are held. Instead, they were booked off balance sheet as contingent liabilities. The market structure that emerged in what came to be the largest market in the global economy was one in which non-tradable contracts were bought by and sold to customers without real time information on volume or pricing or the aggregate positions of the dealers themselves. Moreover, the fact that the contracts were illiquid required constant hedging by dealers that expanded their positions and inflated the size of the market relative to all other national and international financial markets. Meanwhile, the commercial bank dealers' derivatives business was operating with all the implicit guarantees and

subsidies that governments put in place to protect this core financial sector. In 2008, those guarantees became explicit and were exercised.

Are there reasons to protect derivatives dealers?

Because the largest U.S. commercial banks were dominant players in the OTC derivatives markets, Federal Reserve lending, FDIC guarantees and taxpayer bailouts during the 2008 crisis gave explicit protection to both bank and non-bank swap dealers and major swap participants. Those protections are not grounded in the traditions and practices of U.S. financial law and regulation. They are no more appropriate than would be an extension of federal protection to financial entities (including bank affiliates) that market and trade corporate stocks and bonds. Recognizing how far the government's response in 2008 deviated from the existing rational framework for government intervention, Section 716 of the Senate bill makes clear that such protections are not to be given statutory approval; that allowing banks to continue to deal and trade in derivatives would be to accept this egregious violation of prudential standards in legislation intended to reform and strengthen a fragile financial system.

The movement of the largest banks into the business of marketing and trading OTC derivatives occurred during a period when the process of deregulation was sweeping away traditional regulatory barriers and was not challenged. That fact should not, however, lead to the assumption that this is a "normal" banking activity. There is no economic or systemic reason why derivatives should be sold by banks. As the entry of large investment banks into the business in the 1980s suggests, it is not tied to the traditional deposit-taking and lending activities of banks or to the payments system. It is, in fact, so esoteric an activity that, currently, only five institutions account for 90 percent of the market. The remaining 8,000 or so U.S. banks do not sell derivatives or trade them for their own account.

Equally questionable is the assertion that dealing in derivatives is part of banks' role as intermediaries; that they are helping to meet the hedging needs of their customers. As CFTC Chairman Gary Gensler recently pointed out, BIS data show that sales and trades with commercial end-users account for only eight to nine percent of the OTC market. Over 90 percent of contracts involve

transactions between dealers or with other financial institutions. Meanwhile, the events of 2008 have made a mockery of the frequently voiced assertion that derivatives were invaluable in shifting risk to those most able to bear it – unless, of course, the assumption was that those most able to bear it were taxpayers.

Risk and fiduciary responsibility

Housing the business of marketing and trading derivatives in banks intensifies systemic risk and undermines fiduciary responsibility. Buying and selling OTC derivatives contracts is a zero sum game. Unlike portfolio lending that links the fortunes of borrowers and lenders, one party to a derivatives transaction wins while the counterparty loses. Given the nature of the game, dealers must constantly hedge their positions but, unable to do so by trading their side of the contract, their exposures grow higher and higher and include a number of contracts with long maturities. Systemic risk is embedded in this type of market structure – the more so since the buildup in these positions over the decade preceding the crisis depended on short-term borrowing and rising leverage. Touted as a way to defuse risk, the expansion of banks' derivatives business actually intensified it

The buildup in derivatives positions among the large dealers also created a new and dramatically intense form of systemic risk: interconnectedness. The share of total transactions accounted for by contracts between a relatively small group of dealers resulted in an increasingly symbiotic web of interdependence among the largest institutions in the global market. The size of individual dealers' positions contributed to systemic risk but interconnectedness was at the epicenter of the problem.

What section 716 does to alleviate the problem

The most important element in section 716 is the structure it provides – one that makes a clear separation between the business of banking and that of marketing and trading derivatives. This structure makes it possible to protect the core financial functions of banks without extending those protections to cover highly risky derivatives transactions.

By requiring that dealing and trading derivatives move to separately capitalized affiliates that do not have access to Fed lending facilities or FDIC guarantees, section 716 will also contribute to shrinking the size of individual institutions' positions and the market itself. The huge capital reserves of the five institutions that dominate the U.S. market will no longer be available to support their outsized positions. The capital of derivatives affiliates – even if within the same holding company – will necessarily be much smaller and will limit their aggregate positions. This will create opportunities for non-bank firms to enter the market with capital positions equivalent to those of the affiliates of major institutions.

By shifting the activity to affiliates, section 716 eliminates the burgeoning counterparty risk the largest banks incur through marketing and trading OTC derivatives. Encouraging an expansion in the number of dealers will help reduce the risk to the system as a whole. The intent in both the House and Senate bills to require clearing and trading on exchanges using a central counterparty structure is another critical element for alleviating interconnectedness but only if the pressure to create loopholes is resisted.

Are there other provisions that mitigate these risks if banks are allowed to continue selling and trading derivatives?

There are other provisions in the House and Senate bills that address some aspects of bank exposure to risks involving derivatives but none of them remove the government guarantee backing their marketing and trading by banks. For example, the Volcker Rule in section 619 of the Senate bill deals with the equally important problem of proprietary trading by proposing to bar trading in any financial instrument, including derivatives, for a bank's own account. The Merkley-Levin amendment strengthens this provision by making the reform a statutory ban rather than leaving it to the discretion of regulators. In addition, it would crack down on trades that conflict with customers' interests.

But Merkley-Levin is not a substitute for section 716. It would still allow banks to deal and trade on behalf of their clients. Their derivatives business would still be backed and subsidized by Federal Reserve lending and FDIC guarantees and, in the event of another crisis, might require taxpayer bailouts to protect the banking functions of these huge enterprises.

Other sections of the Senate bill – sections 608–611 – address the systemic risk posed by interconnectedness. Section 610 limits a bank’s credit exposure (including derivatives) to another bank or financial institution as a percentage of its capital. This provision will tend to shrink the OTC derivatives market since, as noted, over 90 percent of aggregate transactions involves trades between dealers or with other financial institutions. Another section (608) complements section 716 by limiting a bank’s credit exposure (including derivatives) to affiliates. But, again, banks would still be able to conduct their derivatives business within the bank and the government backing for the bank that constitutes a guarantee and subsidy for selling and trading derivatives would remain.

Both the House and Senate bills authorize regulators to impose aggregate position limits on traded contracts and swaps. These provisions complement both sections 610 and 716 in the Senate bill by allowing regulators to address excesses and imbalances in the derivatives positions of individual institutions and the aggregate market as well. They are a very important tool for strengthening the regulation of derivatives markets but – once more – they do not remove the anticompetitive government support uniquely enjoyed by the derivatives operations of the five largest U.S. financial institutions.

In summary, there are no substitutes for section 716 – no provisions that will accomplish what it does in terms of removing the subsidy enjoyed by (literally) a handful of institutions and ending the ongoing threat to the taxpayer that the guarantee of their derivatives business poses. Ignoring that threat would undermine all the other contributions to reform that the House and Senate bills provide.

Don't Forget The Kanjorski Amendment

The Baseline Scenario » 2010 » June 6/14/10 at 7:22 AM Simon Johnson

By Simon Johnson

Substantive discussion in the House-Senate financial reform reconciliation conference is focusing on the Lincoln amendment, with [some back-and-forth on the Volcker Rule](#) (as manifest in the Merkley-Levin amendment). The [FT reports today that Paul Volcker](#) is no longer opposed to the Lincoln approach – now it has become clear that this is really just about (substantially) raising the capital that banks need to back derivatives trading. And the influential Tom Hoenig, of the Kansas City Fed, appears to be [strongly in the Lincoln camp](#).

While our most experienced regulators weigh in, the lobbyists start to struggle. The [mobilization of broader support](#) against gutting the legislation also helps – the earlier Senate debate has raised sensitivity levels and there is a new concentration to the public scrutiny. The reconciliation process itself is much more open than would ordinarily be the case – [a result of outside pressure](#).

But amidst all this excitement and potential moving parts, don't forget about the Kanjorski amendment (not currently on the [list of most prominent topics](#)).

[The Kanjorski amendment](#) would greatly strengthen the hand of regulators vis-à-vis big banks and further reinforce their power to break up those banks. This is not, unfortunately, the same thing as [the Brown-Kaufman amendment](#), which would have broken up the largest six banks outright.

Still, the [Kanjorski amendment is important for the next time](#) that one or more major banks get into serious trouble. Judging from their current swagger and the slogans you hear from top bankers (“our risk management is now simply amazing”), we only have to wait a few years for the next bailout cycle.

A great deal of discretion would remain with the regulators, and of course this is a potential danger. But the heightened public awareness of the idea that “bailouts are bad” at least increases the chances that management and directors would be replaced in a failing megabank. Whether creditors would face any losses remains a more open question – but at least the Kanjorski amendment, if applied properly, would put that possibility firmly on the table.

Brown-Kaufman was turned back on the Senate floor, but the Kanjorski amendment is an integral part of the financial reform bill that passed

the House. And Congressman Paul Kanjorski is a formidable member of the House conference delegation.

When you argue and push hard this week for the Lincoln amendment and for Volcker-Merkley-Levin, don't forget to also push for the Kanjorski amendment.

They're Just Irrational?

The Baseline Scenario » 2010 » June 6/14/10 at 10:41 PM James Kwak

By James Kwak

Don't get me wrong: I like behavioral economics as much as the next guy. It's quite clear that people are irrational in ways that the neoclassical model assumes away, and you can't see human nature quite the same way after hearing Dan Ariely talk about his [experiments on cheating](#). But I don't think cognitive fallacies are the answer to everything, and I don't think you can explain away the myriad crises of our time as the result of them, as Richard Thaler does in his recent [New York Times article](#).

Like many people, Thaler wants to write about the parallels between the financial crisis and the BP oil leak. For Thaler, the root cause of both crises is that "people in general are not good at estimating the true chances of rare events, especially when human error may be involved" — catastrophic market seizures in the first case, catastrophic oil rig explosions in the latter case.

I have no doubt that it is true that people have problems estimating the chances of certain rare events.* But to stop there is to whitewash the sins of the companies and the executives who created these crises.

First, it doesn't do to say that ordinary people are irrational in making ordinary everyday decisions, and therefore we have to accept that companies will be irrational in making big decisions — like, say, whether to drill holes in the Earth's crust a mile under the ocean. As they say, people make big bucks to make these

decisions, and we expect them to use a little more reasoning than the kind we evolved on the African grasslands.

The problem isn't that people have cognitive biases in assessing unlikely events. When you're dealing with a big company like Citigroup or BP, you have many people applying lots of clever thinking to these problems. The problem is that there is a systematic bias within these companies against certain assessments and in favor of others. That is, the guy who shouts, "Danger! Danger!" will be ignored (or fired), and the guy who says, "Everything's fine, the model says disaster can strike only happen once every hundred million years" will get the promotion — because the people in charge make more money listening to the latter guy. This is why banks don't accidentally hold too much capital. It's why oil companies don't accidentally take too many safety precautions. The mistakes only go one way. You have executives assessing complex situations they don't even begin to grasp and making the decisions that maximize their corporate and personal profits. (Is BP's CEO going to give back years of bonuses now?)

On top of that, it isn't even true, as a matter of fact, that the companies involved failed to estimate the risk of disaster. In a recent [Fresh Air interview](#), Abraham Lustgarten discussed three internal BP memos, written in 2001, 2004, and 2007, each of which warned that the company's culture of inattention to safety — "a consistent emphasis of profits over production over safety and maintenance and environmental compliance," in Lustgarten's words — was creating a high degree of risk. The problem wasn't cognitive fallacies; it was that BP employees were almost certainly falsifying internal inspection reports because of pressure to let production go forward.

This isn't inability to quantify the likelihood of unlikely events; this is willfully looking the other way.

Thaler also wants to make the point that regulators are incapable of understanding the complex technologies involved, whether in finance or in oil exploration. But while this is undoubtedly true to an extent, it also misses the main point.

The most frightening part of Lustgarten's interview has nothing to do with BP.

It's about the use of hydraulic fracturing (or "fracking," apparently with no intended reference to Battlestar Galactica) to drill for natural gas. In fracking, a mixture of water and chemicals is injected underground under extremely high pressure to break up rock formations and release trapped natural gas bubbles. According to Lustgarten, there is no scientific understanding of what happens to those chemicals — many of which are toxic — and whether they end up in our drinking water. Yet the Energy Policy Act of 2005 forbids the EPA from regulating fracking under the Safe Drinking Water Act — by simply stipulating, without proof, that the chemicals are removed after being used, and therefore there is nothing to regulate.

If this reminds you of the Commodity Futures Modernization Act, it probably should. How could this happen? You should listen to the interview because I'm working from memory, but basically the EPA (this is under Bush and Cheney, remember) negotiated the deal with Halliburton and the other gas exploration companies. The EPA agreed to the stipulation, and hence the exemption for fracking, and in exchange the drillers agreed to stop using benzene (or diesel fuel, of which benzene is a component) as a fracking chemical. Years later, however, we now know that the exploration companies simply continued to use benzene as a fracking chemical.

This is what happens when you have a weak regulatory agency crippled by pressure from above (and political appointees who are opposed to regulation) and a private sector that simply does whatever it pleases in pursuit of profits. It's not individual irrationality; it's power, pure and simple. Free market economics has already whitewashed enough egregious corporate behavior. Let's not repeat that mistake with behavioral economics.

* I have always been puzzled, however, by the fact that sometimes people say we underestimate certain unlikely risks, like financial meltdowns, but sometimes people say we overestimate certain other unlikely risks, like dying in a plane accident or a tornado.

After "Financial Reform"

By Simon Johnson

Informed opinion is sharply divided about how the next 12 months will play out for the global economy. Those focused on emerging markets are emphasizing accelerating growth, with some forecasts projecting a 5% increase in world output. Others, concerned about problems in Europe and the United States, remain more pessimistic, with growth projections closer to 4% – and some are even inclined to see a possible “double dip” recession.

This is an interesting debate, but it misses the bigger picture. In response to the crisis of 2007-2009, governments in most industrialized countries put in place some of the most generous bailouts ever seen for large financial institutions. Of course, it is not politically correct to call them bailouts – the preferred language of policymakers is “liquidity support” or “systemic protection.” But it amounts to essentially the same thing: when the chips were down, the most powerful governments in the world (on paper, at least) deferred again and again to the needs and wishes of people who had lent money to big banks.

[to read the rest of this article, on Project Syndicate, [click here](#)]

Why “Living Wills” Fail

By Simon Johnson

A central idea in the financial reforms currently undergoing final negotiation in the United States – and also in similar initiatives in Europe – is that large banks must draw up “living wills” that should explain, in considerable detail, how they will be wound down in the event of future failure.

The concept is appealing in theory. No one knows their business better than the banks, the reasoning goes, so they should have responsibility for explaining how they can close down their various operations – or perhaps sell more valuable parts while limiting losses for unprofitable activities. This is often presented as “smart regulation”, with government regulators requiring private sector experts to do the difficult technical work.

Tuesday’s hearing of the House Energy and Commerce Committee shed considerable light on why living wills are highly unlikely to work in practice. The hearing was actually about the oil industry – and its government-mandated plans to deal with oil spills. The committee posted the [spill response plans for the Gulf of Mexico of five companies](#) – BP, Chevron, ConocoPhillips, Exxon Mobil, and Shell – which demonstrated striking, peculiar and disconcerting similarities.

The glossy covers and photos are different, but it turns out that [all the plans were written by the same subcontractor](#). All contain some goofy details – including how to protect walruses, sea lions, and seals, which don’t actually live in the Gulf. More worrying, given the apparent and complete failure of the BP response at Deepwater Horizon, it appears that none of the major oil companies are more (or less) prepared for such events.

There are three ways to think about this problem in more general terms – across oil extraction, finance, and other sectors.

- 1) The regulators should have done a better job in demanding more detail. But the technical expertise and the highly paid experts are concentrated in the private sector, not in government. If you are willing to raise the salaries of regulators to levels competitive with Wall Street, then we can talk. Otherwise, the regulators will have a hard time second guessing what the experts (and their lawyers) tell them.

- 2) The private sector should take this kind of risk more seriously. Of course this makes sense – but their jobs (and thus their incentives) are about making money, not about protecting the environment or worrying about the social costs of a financial meltdown. Limited time horizons are much more of an issue in finance than in oil exploration and drilling, but the asymmetry of payoffs is quite

parallel – industry executives (and employees, to some extent, and sometimes shareholders) get the upside when everything goes well; the costs, when things go badly, are pushed off onto society. It is completely unreasonable to expect that the private sector will do anything to fix these issues by itself – in fact, as soon as lobbying is politically acceptable again (not when there is maximum political anger, but soon after that dissipates), the oil industry will again be working all its back channels and providing political contributions that oppose tighter regulation. This has definitely been the experience of big finance – in the dog house from September 2008 through spring 2009; but over the past 9 months, again one of the most powerful and well-heeled lobbies in the history of the American republic.

3) The highest levels of government need to decide what we should allow and not allow, in terms of the most risky activities. In the most prescient book written about *Too Big To Fail* in banking, and the trouble that this would bring, Gary Stern and Ron Feldman argued – in the early part of the 2000s – that “penalizing policymakers” should be an important part of how we make credible any commitment not to support megabanks when they fail. Put more bluntly, if you support such banks – you will face electoral consequences. President Obama is now experiencing a form of backlash against years of regulatory capture – and against the pathetic nature of “living wills” for failed deep water oil wells. If he is able to draw any more general lessons – and this remains far from clear – the president would be well advised to reflect on other activities that are simply so dangerous that our obvious and repeated regulatory weaknesses mean we would be better off simply prohibiting (e.g., some kinds of drilling or having big banks). We can debate the case for various kinds of off-shore drilling, but the facts on big banks are cut and dried – there is no social benefit to having banks above \$100 billion (total balance sheet), but we have allowed our largest banks to rise above \$2 trillion and there is every indication that they will keep growing.

It is ironic that while President Obama has done just enough vis-à-vis financial reform to annoy big players who lend to hapless consumers (e.g., payday lenders, who charge incredibly high interest rates) – and to motivate them to oppose his agenda more broadly, he has not substantially addressed what creates so much system risk.

There was a simple and straightforward way to reduce the dangers posed by big banks – to make them smaller with a binding size cap. No serious proponent of this idea argued that it was sufficient for financial stability but the existing and growing consensus is that this would have been completely complementary to other efforts to make regulation more effective, to limit the dangers posed by “financial interconnectedness”, to bring all derivatives onto exchanges, and so on.

But as the Treasury Department now brags to journalists, “If enacted, Brown-Kaufman [the Senate amendment to cap bank size] would have broken up the six biggest banks in America,” a senior Treasury official said. “If we’d been for it, it probably would have happened. But we weren’t, so it didn’t.”

President Obama inherited many problems with regard to offshore drilling, and we have yet to see his full response with regard to the underlying issues of incentives and regulation – or how he will be evaluated, at the end of that day, by the electorate.

But on Big Finance he has had ample opportunity to limit abusive corporate power and he always preferred instead “business as usual” and such illusions as “living wills”.

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It's Not a Bailout — It's a Funeral

The Baseline Scenario » 2010 » June 6/17/10 at 9:30 AM James Kwak

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.

In poetry and politics, metaphor matters. Expect some fighting figures of speech on Thursday, when the conference committee takes up the topic of the Orderly Liquidation Fund or “OLF.” Under the proposed financial reform legislation, the OLF is the facility that would hold the money needed by the FDIC to shut down a systemically important, insolvent financial institution before its failure can contaminate other firms and the broader economy. In other words, one purpose of the resolution authority and OLF is to avoid repeating the disorder and disruption of either the Lehman bankruptcy or the AIG bailout.

To be clear, many question whether regulators will have the courage to invoke this provision and pull the plug on a dying bank. Accordingly, the “prevention” measures under discussion in the legislation are critical — these included the swaps desk spinoff, hard leverage caps on financial firms, regulatory oversight over shadow banks and inclusion of off-balance sheet transactions in capital standards, among others.

One of the hottest debates concerning funding the OLF is over who should pay into the fund and when should they pay. On the question of “who,” the choices have been framed as either industry or taxpayers. And the “when” options are described as in advance of or after a failure. Many, including the House majority in its bill and FDIC Chairman Sheila Bair, [support](#) an up-front assessment on industry. Those who oppose an industry pre-fund have tried to damn the OLF as a “bailout fund” and at times the financial reform legislation as a “bailout bill.”

It’s laughable that big-bank-boosters only characterize it as a “bailout fund” when the banks pay in advance, but not when taxpayers front the money. It’s tragic, though, when we fall for this propaganda, disseminated by some truth-twisting Republican political strategists. But that’s exactly what happened when that fiction effectively killed the industry pre-fund in the Senate bill. As Paul Krugman noted, politicians continue to repeat these twisted [talking points](#) because they hope that if they slap the “bailout” label on any provision of the bill that gets tough on big banks, we will be fooled into backing down.

But we cannot be fooled. The proposed legislation is not a bailout. It is a funeral. A bailout involves using money to revive a failing business so that it can continue operations. In contrast, under both the House and Senate versions of the legislation, the FDIC is given the power to dismantle, shut down and liquidate failing firms. Liquidation means the end of the enterprise. Liquidation requires the valuation and sale of eligible assets, including healthy subsidiaries. It's a funeral.

That's good. But, unfortunately, under the Senate version of bill, the taxpayers front the funeral expenses. Let me repeat. The taxpayers front the funeral expenses of the failed firm. The FDIC can borrow from Treasury who can then issue debt. It's true. And it's very important. The reason is that funding is needed to process a liquidation. Depending upon the number of firms collapsing, this could be in the hundreds of billions of dollars.

The money is needed to avoid a sudden halt of business that causes the financial firm's viable assets (such as the remaining enterprise value of a healthy subsidiary) to plummet in value. Funds would allow the firm to keep functioning so that an orderly liquidation can occur. The money would be used to put the failing firm into a bridge entity, then manage it and wind it down. The proceeds of the sale of eligible assets and functioning subsidiaries would be used first to replenish the OLF. With the Senate version, any proceeds would be used first toward paying back the loan from Treasury. Of course, not all assets are eligible to be sold. Creditors with security interests (and otherwise given special protection) can pull their assets away from the receivership. To protect against this, the House version allows the FDIC to require these secured creditors to leave behind 10 percent of their collateral. Known as the "secured creditor haircut," this mechanism does not exist in the Senate version; it should, particularly given that it would be a good resource to pay back the taxpayers.

While the debate has been framed as either a pre-fund or a post-fund, this is a false dichotomy. There will have to be money available when the failing firm is taken into receivership. There will be pre-funding, period. So, the true story is that if the banks do not pay in advance, we will, and then the only questions becomes who will pay us back and when.

Now is the time to address this issue. While taxpayers should support the House

industry-pays-in-advance-for-its-own-funerals, version, given the strange power of doublethink, we are in danger that the Senate taxpayer-fronted-funeral process will survive conference committee and make it into the final law.

The House model requires financial institutions to pay \$150 billion in advance into the OLF (called the Systemic Dissolution fund in the House version). An industry pre-funded facility has precedent. The FDIC relies upon bank assessments to fill the deposit insurance fund (the “DIF”). The DIF is most well known for insuring the money bank account holders have on deposit. It also, however, is used to pay the various expenses associated with the liquidation of covered banks. Another precedent is the Pension Benefit Guarantee Corporation. Pension plan sponsors provide funding through an assessment. The resulting fund is used to pay certain employee pension benefits in the event the employer firm goes into bankruptcy.

The Senate bill requires taxpayers to front the costs of liquidating failing firms. The amount FDIC can borrow from treasury is capped by a “Maximum Obligation Limit” calculation. This is in two parts. In the first 30 days of receivership, the FDIC can borrow from Treasury up to 10% of the “total consolidated assets” of the failing firm based upon the most recent financial statement available. So, for a bank with about \$800 billion in assets, the FDIC could borrow from Treasury \$80 billion in that 30 day window.

Then, in part two, after examining the firm and better determining the value of its assets (and what funding will be needed for orderly liquidation), the FDIC can borrow from Treasury up to 90% of the fair market value of total consolidated assets “available for repayment.” It’s important to note that there may be very few assets if any available for repayment — if, as noted above, secured creditors pull their collateral — so these will not be eligible.

The FDIC is required to pay back the Treasury within 60 months (five years), using the proceeds of the sale of assets, if there are enough. If the firm is so broke that the assets are not sufficient to pay back the FDIC, then the FDIC is supposed to claw back extra amounts paid to certain creditors, and if that doesn’t work out, an ex-post industry assessment on “eligible financial institutions” is permitted.

Thus the taxpayers may be “out-of-pocket” for up to five years or beyond. Given that one of the greatest objections to the Bush Bailout of 2008 was the burden on taxpayers, how did this happen? Opponents of the bank pre-fund claim that the existence of a fund would encourage banks to take high risks because they know that they will be bailed out. This ignores the fact that both the House and Senate bills would impose stricter standards on these institutions, requiring them to have more capital cushions in the event that the assets they own decline in value (a common part of the business cycle). Thus, the risk-taking will be monitored and minimized. In addition, given that firms will be liquidated not rescued, this argument is silly.

Perhaps there’s a third option, an industry paid “Just-in-Time” mechanism. Just-in-Time mean would mean assessing “eligible financial institutions” at the moment of FDIC receivership. And, instead of leaving the allocation formula as a mystery until some future date, the legislation could require the new council of regulators (the Financial Stability Oversight Council) to come up with a methodology that would be transparent to each firm.

Of course, there are plenty of arguments against this approach. One argument is that it is unworkable because the assessments come too late. I agree that it is better to collect “rainy day” resources on a sunny day. And, I support the House’s \$150 billion pre-fund approach. Representative Luis Gutierrez, from Illinois’s 4th District, is going to lead this charge on the House side during conference on Thursday. If we can convince the Congress to do that, terrific. But, that is not the message some conference committee members are signaling.

Some might also worry that such a Just-in-Time assessment on industry would be difficult to collect if there were a massive failure a la September 2008. Implicit in this argument is that the liquidation of one firm means a full blown financial crisis has hit. This is not necessarily the case. An FDIC-run liquidation could be a Bear Stearns (March 2008) moment, not a Lehman (September 2008) moment, or even a single, stand alone troubled firm. And, even if it is the Lehman moment, recall that the weekend before Lehman filed for bankruptcy, industry rivals were assembled together ready to buy up its bad assets so that Barclays might buy the good ones. While this transaction fell apart when the UK regulators reasonably insisted that shareholders at Barclays get to vote on the

deal, the point is that the top financial institutions were prepared to help.

However, the Just-in-Time language could be drafted in such a way that a firm's condition could be considered before deciding upon the amount of the up-front assessment. If a firm is too unhealthy to pay in, it could be granted a deferred assessment. In the case of a "one-off" failure, with a fairly isolated insolvency and many healthy firms, it would be a good time to avoid moral hazard and show industry that they, instead of the taxpayers must front the costs of the liquidation. In other words, suggesting the firms won't have the money when a firm goes into receivership is only a hypothesis. Another hypothesis is that many will. Congress should prepare for both so that passing the hat around to industry happens before we are asked to pinch our pennies and pitch in.

The bottom line is, when a behemoth bank burns the candle at both ends and then goes belly up, it's polite to pay our respects, but it's ridiculous to pay the bill.

G-20 Rules; Time for Germany-Bashing

The Baseline Scenario » 2010 » June 6/20/10 at 9:11 AM Simon Johnson

This guest post is by [Arvind Subramanian](#), senior fellow at the Peterson Institute for International Economics.

Yesterday's announcement by China to introduce greater exchange rate flexibility is unambiguously good news. Greater currency flexibility will help China with its domestic overheating problem. But China deserves a lot of credit for its act of responsible international citizenship, for making its contribution to global re-balancing. Two implications follow.

First, the G-20 deserves a lot of credit for the change in China's policy. True, Secretary Geithner played his cards skillfully, balancing private chiding with public encouragement. It is also true that recent sabre-rattling by the US Congress to impose trade measures against Chinese exports may have played a

role in persuading China. But it is the fact of the G-20 that allowed Secretary Geithner to convert the China currency issue from a bilateral US-China matter (on which little progress had been made for many years) to one in which a broader set of countries had a stake. The public pronouncements by Brazil and India earlier this year re-inforced this “multilateralization” of China’s currency undervaluation. This multilateralization had two positive effects. It forced China to take more seriously the international consequences of its currency policy. And it also made the politics of changing policy easier because China is seen not as caving to bilateral pressure but as responding to the wider international community. Regardless of what happens at the G-20 Summit in Toronto over this week-end, the G-20 can already count the change in China’s currency policy as its victory.

The second implication is this: with China having made its contribution to global re-balancing, it is time to demand the same of Germany, which is the other large surplus country in the world economy, and which has just received a steroidal boost of competitiveness with the decline of the euro. Where China was an intentional mercantilist, Germany has become an accidental mercantilist, which will further increase its current account surplus. But Germany has responded by announcing fiscal consolidation. Some have excused this action on the grounds that the tightening involved would be small and back-loaded. But this misses the key point: Germany’s action has the wrong sign: it should be expanding demand, not just for the sake of global re-balancing but to provide some growth impetus to its dire Southern European neighbors. But in fact it is now reducing demand. If this continues, the spotlight will have to be on Germany. China-bashing is now likely to cede to Germany-bashing.

Dead On Arrival: Financial Reform Fails

The Baseline Scenario » 2010 » June 6/21/10 at 7:04 AM Simon Johnson

By Simon Johnson

The House-Senate reconciliation process is still underway and some details will

still change. But the broad contours of “financial reform” are already completely clear; there are no last minute miracles at this level of politics. The new consumer protection agency for financial products is a good idea and worth supporting – assuming someone sensible is appointed by the president to run it. Yet, at the end of the day, essentially nothing in the entire legislation will reduce the potential for massive system risk as we head into the next credit cycle.

Go, for example, through the summary of “comprehensive financial regulatory reform bills” in [President Obama’s letter to the G20 last week](#).

The president argues for more capital in banking – and this is a fine goal, particularly as the Europeans continue to drag their feet on this issue. But how much capital does his Treasury team think is “enough”? Most indications are that they will seek tier one capital requirements in the range of 10-12 percent – which is what Lehman had right before it failed. How would that help?

“Stronger oversight of derivatives” is also on the president’s international agenda but this cannot be taken seriously, given how little Treasury and the White House have pushed for tighter control of derivatives in the US legislation. If Senator Lincoln has made any progress at all – and we shall see where her initiative ends up – it has been without the full cooperation of the administration. (The WSJ today [has a more positive interpretation](#), but even in this narrative you have to ask – where was the administration on this issue in the nine months of intense debate and hard work prior to April? Have they really woken up so recently to the dangers here?)

“More transparency and disclosure” sounds fine but this is just empty rhetoric. Where is the application – or strengthening if necessary – of anti-trust tools so that concentrated market share in over-the-counter derivatives can be confronted. The White House is making something of [a show from Jamie Dimon falling out of favor](#), but all the points of substance that matter, Dimon’s JP Morgan Chase has won. The Securities and Exchange Commission is beginning to push in the right direction, but the reconciliation conference looks likely to deny them the self-funding – CFTC and FDIC, for example, collect fees from the industry – that could help build as a regulator. At the same time, the conference legislation would send a large number of important questions to the SEC “for

further study”. None of this makes any sense – unless the goal is to block real reform.

The president also asks for a “more effective framework for winding down large global firms” but his experts know this is politically impossible. The G20 (and other) countries will not agree to such a cross-border resolution mechanism – and this was an important reason why Senators Sherrod Brown and Ted Kaufman argued so strongly that big banks had to become smaller (and be limited in how much they could borrow). Now administration officials [brag to the press, on the record](#), about how they killed the Brown-Kaufman amendment. These people – in the White House and around the Treasury – simply cannot be taken seriously.

And as for “principles for the financial sector to make a fair and substantial contribution towards paying for any burdens”, this is a sad joke. This is not an oil spill, Mr. President. This is the worst recession since World War II, a 40 percentage points increase in government debt (attempting to prevent a Second Great Depression), loss of at least 8 million jobs in the United States, and a painfully slow recovery (in terms of unemployment) – not to mention all the collateral damage in so many parts of the world, including Europe. Could someone in the White House at least come to terms with this issue and provide the president with a sensible and clear text? Honestly, as staff work, this is embarrassing.

There is great deference to power in the United States, and perhaps that is appropriate. But those now calling the shots should remember that they will not be in power for ever and – at some point in the not too distant future – there will be a more balanced assessment of their legacies.

Simply claiming that the president is “tough” on big banks simply will not wash. There are too many facts, too much accumulated evidence, pointing exactly the other way. The president signed off on the most generous and least conditional bailout in world financial history. This is now widely understood. The administration has scrambled to create some political cover in terms of “reform” – but the lack of substance here is already clear to people who follow it closely and public perceptions will shift quickly.

The financial crisis of fall 2008 revealed serious dangers have developed in the heart of the world's financial system. The Bush-Obama bailouts of 2008-09 confirmed that our biggest banks are "too big to fail" and the left, center, and right can agree with Gene Fama [when he says](#): "too big to fail" is perverting activities and incentives.

This is not a leftist message, although you hear people on the left make the point. But people on the right also increasingly understand what is going on – there is excessive and abusive power at the heart of our financial system that completely distorts markets (and really amounts to a hidden, unfair and dangerous taxpayer subsidy).

This administration and this Congress had ample opportunity to confront this problem and at least wrestle hard with it. Some senators and representatives worked long and hard on precisely this issue. But the White House punted, repeatedly, and elected instead for a veneer of superficial tweaking. Welcome to the next global credit cycle – with too big to fail banks at center stage.

Paul Krugman For OMB

The Baseline Scenario » 2010 » June 6/22/10 at 12:13 PM Simon Johnson

By Simon Johnson

The president should nominate Paul Krugman to replace Peter Orszag as director of the Office of Management and Budget (OMB). (Orszag [resignation details](#) are here.)

We have previously reviewed Krugman's outstanding qualifications for this (or any other top level) job ([link to details](#)). The main reason Krugman himself has been reluctant in the past relates to a potentially difficult Senate confirmation hearing – for example, if Krugman had been put forward to replace Ben Bernanke.

But for the OMB position, the dynamic of a hearing would be terrific for the president's specific agenda and broader messages. Krugman, of course, is the leading advocate for continued (or increased) fiscal stimulus. This is exactly President Obama's message to the G20 this weekend.

Plus, when Republicans push back against Krugman on this issue, he will let them have it full blast on fiscal policy during the Bush administration. Krugman has, again and again, been an outspoken critic of the Bush era fiscal policy. He has precise chapter and verse on where the Bush team went off the deep fiscal edge.

Krugman also stands for responsible medium-term fiscal policy – he wrote the original definitive work, after all, on balance of payments crises. But the point is not to engage in precipitate and panicky fiscal austerity (as announced in the UK today), but rather to put the overall debt onto a sustainable path. It is very hard to do that when the people claiming the represent “fiscal prudence” are actually the ones who created this massive mess in the first place. Krugman can set the public record straight on this – it would be great television and very good economics.

This is exactly what the debate on our current deficit and future debt path needs. The Obama administration lost the narrative on this point also (as well as on banking and much more). Paul Krugman can get them back on track.

[“Chuck Prince” Is Going To Run This Bank \(Into The Ground\)](#)

The Baseline Scenario » 2010 » June 6/23/10 at 6:51 AM Simon Johnson

By Simon Johnson

“Breaking up big banks would actually increase system risk” is a refrain heard from top administration officials, ever more vocal after they helped kill the Brown-Kaufman amendment (that would have limited the size and leverage of

our largest banks) on the floor of the Senate.

But while Mr. Geithner and his colleagues are still taking their victory laps and congratulating themselves on retaining “business as usual” after the biggest crash-and-bailout in world financial history, educated opinion starts to feel increasingly uncomfortable.

People who worry seriously about system risk break the problem down into several distinct buckets, including the nature of shocks and the way these are propagated across the system. In this typology, the “Chuck Prince problem” is in a class of its own.

It might be fairer to label this issue as the Royal Bank of Scotland problem – because RBS had a balance sheet that reached roughly 1.5 times the size of the British economy before it failed. Or perhaps we should call it the Irish problem – three banks with combined assets around 200 percent of the Irish economy, and then they failed. Or even the Iceland problem – three banks that were 11-13 times the size of the Icelandic economy before they went belly up.

But all of those overseas examples still seem rather esoteric to American audiences – at least, that’s my experience after presenting [*13 Bankers: The Wall Street Takeover and The Next Financial Meltdown*](#) over 50 times to audiences around the US over the past few months. Recent European experience points to our likely future – huge banks that herd into bad mistakes and, when bailout time comes, further imperil states that have already weak fiscal positions. But most Americans are not quite willing to say we are there yet.

So we will stick with the Chuck Prince label. The point is that while many banks are run by good risk managers for a while, they all eventually end up in the hands of someone who does not really know what is going on.

Banks are bureaucratic power structures, after all, albeit ones that try to make money after some fashion. The people who rise to the top are not always the most risk averse – more likely they get on with the boss or reflect someone’s glory in an appropriate manner or are just not that threatening to the people who matter.

Under our existing rules, good managers can build up banks and – with the continuing lack of effective cap on the size of big banks – these institutions can become huge relative to the economy. And then Chuck Prince gets the job.

The interesting thing about Mr. Prince, of course, is that he does not claim to have known what was going on. In fact, in his testimony to the Financial Crisis Inquiry Commission he rather emphasized that he was not fully informed or otherwise aware of the risks being taken by Citigroup – which he headed.

This “Chuck Prince” problem is exactly what would have been addressed by Senators Ted Kaufman and Sherrod Brown. And it is exactly what this administration ducked. Find me a systemic risk expert – and I’ve been talking to the very best – who thinks what the administration did was a good idea.

The next time a megabank fails, do not send to know for whom the bell tolls. It tolls for Tim Geithner and Larry Summers (as well as probably 25 million or so people around the world who will lose their jobs in the ensuing recession). Failing to break up the biggest banks was a policy mistake for the ages. Senators Brown and Kaufman handed this opportunity to Treasury on a platter – but they knocked it over, trampled it into the ground, and now [brag about their feat to the press](#).

This was pure hubris on the part of the administration, with perhaps some NIH (“not invented here”) thrown in – if they didn’t invent an idea, they can’t believe it’s worth pursuing.

The next time a big bank crashes and burns – causing vast economic damage – you can blame Chuck Prince (or his latest incarnation) if you wish. Or you can blame the people who hired the Chuck Prince-equivalent. But I would respectfully submit that most of the blame lies with the folk who thought it was OK to continue allowing the existence of megabanks that can be mismanaged into utter disaster.

The “Chuck Prince” problem is a completely unnecessary source of system risk that could have been removed by this administration.

Tim Geithner and Larry Summers Need Paul Krugman To Replace Peter Orszag

The Baseline Scenario » 2010 » June 6/24/10 at 6:15 AM Simon Johnson

By Simon Johnson. Tim Geithner and Larry Summers are [talking a good game](#) on fiscal policy to the G20. But they are struggling with to establish traction for their “spend now, consolidate later” message. Fortunately, there is an easy and obvious opportunity to establish credibility on this issue: Bring Paul Krugman into government.

Earlier this week, Peter Orszag resigned from his cabinet position as director of the Office of Management and Budget. The Washington Post put out one of the first lists of [candidates](#) who could replacement him. Senator Byron Dorgan would be a smart pick and some of the Post’s other suggestions could make sense.

But surely the front runner is Jason Furman. The working assumption is that Treasury Secretary Tim Geithner and National Economic Council director Larry Summers are in positions of influence for the long haul – and they have a track record of preferring team players over people who could bring competing perspectives to the table.

The Hamilton Project, housed at the Brookings Institution, was designed as a government-in-waiting by Robert Rubin. Then-Senator Obama [attended its inaugural public meeting](#), with Peter Orszag as head of the project. Appointing Furman, successor to Orszag at Hamilton and currently a deputy to Larry Summers at the NEC, or another person from the same wing of the Clinton administration would continue in this tradition.

This is unfortunate, because the brilliant choice would be Paul Krugman - completely taking the wind out of the Republicans’ sails on fiscal deficits. Krugman has scolded them, in real-time and to great effect, consistently with regard to ruining the budget. And he has an important point – the Bush

administration inherited a fairly sound fiscal position from the Clinton administration but squandered it thoroughly over 8 years.

At the same time, the Republicans allowed unprecedented system risk to develop in the big banks. To be sure, the Clinton administration shares responsibility for excessively deregulating financial institutions and derivatives – a point that even President Clinton now concedes. But the rather more pointed partisan point is that the contingent fiscal liability posed by an out-of-control financial system became much larger during the Bush years.

The purely fiscal damage wrecked by big banks – apparent in 2008 but building for longer – will end up increasing our net government debt held by the private sector by around 40 percentage points of GDP. That's the likely final cost of the "automatic stabilizers" (i.e., tax revenue falls and we spend more on unemployment benefits during a recession) plus the discretionary fiscal stimulus that was undertaken with the – entirely reasonable – goal of preventing a Second Great Depression in early 2009. Around half of our existing government debt burden and much of our continuing fiscal vulnerability is due to the dangers posed by unreformed big banks.

Vice President Dick Cheney is famously associated with the catch phrase, "deficits don't matter." Yet "cut budget spending now" and "President Obama is fiscally irresponsible" are the slogans that come increasingly from Cheney's part of the political spectrum. It would be a great move to give Krugman (and his Nobel Prize) the OMB podium from which to respond. Even the confirmation hearing would be fiery and memorable – and get the right points across.

Krugman embodies exactly the balance of messages required to be an effective budget director today. He fully understands the need for budget consolidation eventually – after all, he wrote the original definitive work on balance of payments crises and how these are fueled by money creation (and implicitly by budget deficits). No one has better anti-deficit credentials for the long haul. And, as one of the world's leading economists on international issues, he understands better than most both the advantages granted the United States because we issue one of the few "reserve currencies" (held by private investors and central banks alike as a safe haven).

He also knows that if we don't put our public debt eventually on a stable path, we could lose our reserve currency status – in which case our problems would begin to resemble much more those of Greece. Greece has substantially higher debt relative to GDP than we do (they are over 100 percent of GDP, on their way to 140 percent; we're crossing 60 percent, on our way to 80 percent), and its budget deficit looks more intractable. But the ultimate difference is that when the world's financial markets look scary and investors want to duck for cover – they run into US government obligations, and away from paper issued by governments such as Greece.

The trick, therefore, is absolutely not to engage in overly rapid fiscal contraction. This is what President Obama is warning the G20 against – although so far with little effect. The new British government, for example, seems keen to engage in excessively precipitate spending cuts and tax increases.

We need instead to set achievable medium-term fiscal targets that will stabilize our debt levels. If these are credible, this gives us the space and time we need to put our fiscal house in order without experiencing the kind of fiscal austerity that would only make our current high unemployment problems worse.

To give Peter Orszag and his colleagues – such as Tim Geithner – credit, they have tried to get this message across. But unfortunately, they have not had the stature, the top-level political support, or the kind of voice needed to really pull off what is, after all, a delicate balance that must be explained far and wide with great credibility.

The danger is that the next budget director will too much lean towards the prevailing – and incorrect – Wall Street “wisdom” that we need Southern European style austerity and now.

If the president wants to actually make progress his broader agenda, and to experience anything other than austerity and prolonged high unemployment, Paul Krugman would be the best choice for budget director.

An edited version of this post appeared this morning on the NYT's Economix. It is used here with permission and if you would like to reproduce the entire article,

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JP Morgan Responds To Financial Reform: The Poison Pill Strategy

The Baseline Scenario » 2010 » June 6/26/10 at 8:00 PM Simon Johnson

By Simon Johnson

While the financial reform negotiation process grinds to its meaningless conclusion, the real action lies elsewhere – in Jamie Dimon’s executive suite.

Dimon, the head of JP Morgan Chase, is [apparently seeking](#) to (a) become more global, (b) move further into emerging markets, and (c) become more like Citigroup.

This is terrific corporate strategy – and very dangerous for the rest of us.

Jamie Dimon clearly wants to become too big to fail, too interconnected to fail, and – above all – too global to fail.

He knows that the reform package will, [among other \(very small\) things](#), create a resolution authority that will give the government more power – in principle – vis-à-vis failing financial institutions in the future. This is a central part of Tim Geithner’s vision for financial stability.

But Mr. Dimon also knows – as a board member of the NY Fed and sometime White House/Treasury confidante – that a US resolution authority will do precisely nothing to make it easier to handle the failure of a large global bank, e.g., Citigroup, doing business in over 100 countries.

The reason global megabanks will get bailouts in the future is simple – policymakers will fear the chaos that would ensue when competing bankruptcy claims swarm over a defaulted institution, much as happened for Lehman (e.g., in London) in September 2008.

Mr. Dimon and his colleagues – who include some top former global regulators – are also well aware that the G20 (and everyone else) will not make any serious push towards creating a cross-border resolution mechanism.

The best way to signal to creditors that they will be protected in all potential future crises is to make JP Morgan bigger and more global. This will lower the funding costs for the organization and in turn make this global expansion more profitable when times are good – and when times are bad, there will be government support.

In effect, Mr. Dimon is constructing a “poison pill” against takeover by the government. This is so simple, so brilliant, and so dangerous that it should take your breath away.

If you press serious administration officials, in private, on how they will use the new resolution authority for Citigroup or (now) JP Morgan Chase, they are quite candid: they would create a conservatorship, as with AIG or Fannie/Freddie. But there is a huge difference between conservatorship and resolution. Resolution is about winding down the company, typically involves firing, and should imply losses for unsecured creditors. Conservatorship is about managing the company as a going concern – and would almost certainly in this context involve full creditor protection.

It is perhaps ironic that Jamie Dimon [argued strongly](#), early in the reform process, for a heavy weight to be placed on a resolution authority as a way to prevent future bailouts. His actions now to undermine the effectiveness of such an authority further suggest that this administration was unwise and naïve to rely on his advice in the early formative phases of reform.

The White House [may now be waking](#) up to the profound dangers that Mr. Dimon [and his successors](#) will pose, but they are still unwilling to do anything meaningful about it.

By Simon Johnson

The next financial boom seems likely to be centered on lending to emerging markets. Sam Finkelstein, head of emerging markets debt at Goldman Sachs Asset Management, summed up the prevailing market view – and no doubt talked up his own positions – with a [prominent quote](#) in Monday's Financial Times (p.13, front of the Companies and Markets section):

“Debt-to-GDP ratios in the developed world are about double those in emerging markets and they're growing. This makes emerging markets interesting because you're pick up incremental spread [higher interest rates compared with developed world rates], and in return you're actually taking less macroeconomic risk.”

This is a dangerous view for three reasons.

First, against all historical evidence, it assumes that the only macroeconomic risks we should worry about – in general or for emerging markets – are related to standard measures of government fiscal policy. “Less risk” and “more yield” was exactly what securitized subprime mortgages and their derivatives were purported to offer; this combination typically proves illusory.

Second, emerging markets got into serious trouble through private sector overborrowing both in the 1970s (Latin America, communist Poland and Romania) and in the 1990s (many parts of Asia). In some crises, the government stepped in and ended up holding a great deal of debt – but this does not change the fact that the exuberance was all about private sector banks (in the US and Europe) lending to private sector corporations (financial and nonfinancial) in a mispricing of risk that started out at modest levels but grew over the cycle.

Third, when your ability to borrow depends in part on the value of your collateral – see the [academic work of Ben Bernanke](#) and the experience of Japan in the

late 1980s (e.g., the classic [Hoshi-Kashyap volume](#)) – then rising asset prices enable you to borrow more. This does not necessarily have to go bad in a macroeconomic sense, but experience over the last 30 years is not encouraging. Global moral hazard – the idea that someone will provide a bailout – does not mix well with free capital flows and this kind of financial accelerator.

Goldman Sachs knows all this, of course. But, as they will tell you correctly, reforming incentives or even discouraging this kind of cycle is definitely not their job. Their role is to make money, pure and pretty simple given their market share.

It's the responsibility of government to make the world financial system less dangerous. Judging from the G20 summit (see [my comments on the communique](#)) this weekend, we are making no progress at all in that direction.

The Private Sector Fallacy

The Baseline Scenario » 2010 » June 6/30/10 at 5:57 PM James Kwak

By James Kwak

[Felix Salmon](#) highlights an important point to bear in mind when it comes to banks and short sales. Actually, it's an important to bear in mind when you're thinking about any big private sector company, be in Citigroup or British Petroleum. Yes, companies do things in their own self-interest that hurt other people and may not be net benefits to society. But they also do things that are not in their own self-interest all the time, because companies just aren't all that efficient.

Felix's post is largely about two factors. One is that big company executives are prone to exactly the same sort of cognitive fallacies as ordinary people, and hence make stupid decisions routinely. The second is that the incentives of individual people who make decisions (or provide information to people who

make decisions) are only tangentially related to the interests of the company as a whole, and certainly not when you think of those interests over the long term.

A third factor is simply that companies are big, dumb, poorly designed institutions. There's lots of talk about how individual human beings do not resemble the rational actors of textbook economic theory. The same is at least as true of big companies, of which I have seen many, from various perspectives.

Yet the belief that the private sector is the answer to all our problems remains deeply rooted. One might even call it an ideology. I would hope that the financial crisis (and the BP disaster) might cause people to question that ideology, at least a little bit.