

By Simon Johnson

The G20 communiqué, released after the Toronto summit on Sunday, made it quite clear that most industrialized countries now have budget deficit reduction fever ([see this version](#), with line-by-line comments by me, Marc Chandler and Arvind Subramanian). The US resisted the pressure to cut government spending and/or raise taxes in a precipitate manner, but the sense of the meeting was clear – cut now to some extent and cut more tomorrow.

This makes some sense if you think that the global economy is in robust health and likely to grow at a rapid clip – say close to 5 percent per annum – for the foreseeable future. With high global growth, it will matter less that governments are cutting back and unemployment will come down regardless. Taking this into account, the IMF is actually predicting (as cited prominently by the G20) that budget “consolidation” actually raise growth over a five-year horizon.

There is no question that some weaker European countries, such as Greece, Portugal, and Ireland, had budget deficits that were out of control. Particularly if they are to pay back all their foreign borrowing – a controversial idea that remains the conventional wisdom – these countries need some austerity. But what about those larger countries, which remain creditworthy, such as Germany, France, the UK, and the US? If these economies all decide to reduce their budget deficits, what will drive global growth? The answer in Toronto was obvious: China. China is only about 6 percent of the world economy, measured using prevailing exchange rates, but it has a disproportionate influence on other emerging markets due to its seemingly insatiable demand for commodities. It also has a relatively healthy fiscal balance – and its fiscal stimulus, working mostly through infrastructure investment, did a great job in terms of buffering the real economy in the face of declining world trade in 2008-09.

Now, however, the Chinese government is trying to slow the economy down – there is fear of “overheating”, which could mean inflation or rising real wages (depending on who you talk to). Chinese economic statistics are notoriously unreliable, so reading the tea leaves is harder than for some other economies, but most of the leading indicators suggest that some sort of slowdown is now underway.

The G20 knows this, so the bet is that China will pull off a “soft-landing”, with growth staying in the region of 8-9 percent. China’s recent exchange rate appreciation against the dollar does not help in this regard, and this is one reason why pressure for further appreciation from other governments is likely to remain muted. Even the United States, above all, wants a robust China.

Talking to Chinese experts – I was in Beijing over the weekend – there are three major worries.

- 1) There is already a great deal of wasteful investment in infrastructure. At some level, there is a desire to clean this up and make it more sensible. This implies slower growth.
- 2) There is much discussion of “overcapacity” in the state sector. Again, there is interest in addressing this – although it is not an easy problem. In any case, this further lowers the incentive for state investment both directly and through various forms of subsidies to government-backed enterprises.
- 3) The incentives for local government officials have been heavily weighted towards boosting GDP growth; they move up (and presumably down) the government and party hierarchy based on how they do in this dimension. There is now a great deal of thinking that it would be better to also include other objectives, such as impact on the environment. This makes sense – air and water quality are hot issues – but it would also imply slower growth.

China's reported GDP numbers are likely remain robust – the reported statistics are very much part of the broader government management process. But the economy could still slowdown in ways that would impact commodity prices – these are the key variables to watch, including for energy and metals used in industrial production (e.g., for the link to Latin America, see [the NYT today](#)).

The irony, of course, is that China is also a leading candidate to be at the epicenter of the next boom. In a sense this is what the G20 would like, unless the boom becomes debt-based and unsustainable, as in emerging markets during the 1970s or Japan in the late 1980s.

The G20 is betting that China can keep its growth high enough to sustain the global economy while also not getting drawn into some sort of bubble – particularly one that would involve big Western banks. Given the nature of China and the volatility of global capital flows – international investors love you without limit, until the moment they leave you – this is quite a bet.

We should also not overestimate the ability of the Chinese government to fine tune its economy. To be sure, the authorities have done well both in terms of high average growth and in terms of managing the impact of regional and global cycles over the past 20 years. Can they really do so well indefinitely?

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[State Banking, Globally](#)

By Simon Johnson

A standard refrain from U.S. banking industry lobbyists is “you cannot put us at a disadvantage relative to our overseas competitors.” The Obama administration has largely bought into this line and cites it in public and private as one reason for [opposing size caps on our largest banks](#) and preventing Congress from raising capital requirements.

The US Treasury puts its faith instead in the [Basel Committee on Banking Supervision process](#), a somewhat murky convocation of bank regulators from various countries that has a weak track record in terms of setting sufficient prudential standards (also [the assessment of Dan Tarullo](#), now an influential Federal Reserve governor; disclosure, I have a part-time position at the Peterson Institute, which published his book). But, the official US reasoning goes, the crisis of 2007-08 was so traumatic, our European counterparts will now want to be more careful.

The problem with this approach is that there is a fundamental and widening gap between how banks are seen in the United States compared with other leading countries. To some extent this is about tradition – from the early 19th century the US has a long history of suspicion regarding the political and economic power of banks, whereas Germany has tended to have a more cooperative relationship between the state and big banks. It is also about what we think government should do – our “pro-banking” group in government draws a lot of support when it insists that the federal authorities should not run banks, but in France there is much less reluctance to mix politics and financial business.

All of this matters because if a government stands behinds its banks, those banks need much less capital in order to be viable. Capital is a buffer against losses – it represents the shareholders’ wealth and as such “absorbs” the damage caused by bad loans or disastrous purchases of securities. If a bank’s capital falls to zero (or below), it is out of business – unless it can raise new capital, which would typically be hard to do from private markets for a failed bank.

But if the state stands behinds its banks, it will be more willing to “inject” capital as needed. Government officials may not want to do this as a matter of routine – primarily because that would worsen the moral hazard problems of the banks’ management, i.e., they would have no incentive to be careful. It could also be politically unpopular to provide too much support in this fashion.

Still, there is no question that while we wait for the public results of the European bank stress tests, the relevant governments are making it quite plain that their big banks will not be allowed to fail. We shall see if this commitment comes with more effective corporate governance and personnel changes than was the case in the United States – when the [top 13 Bankers](#) (and almost everyone else in leading financial institutions) were bailed out unconditionally.

In any case, the global competitive landscape is changing unambiguously. Despite all the obvious incentive problems in the eurozone writ large (including irresponsible lending at many levels), the state is not retreating from banking in Europe – on the contrary, it is becoming more deeply

committed. Under these circumstances, the Basel process is even less likely to lead to a meaningful increase in capital requirements. Even if the headline numbers look reasonable, there will be so many exemptions and exceptions – at European insistence – that the ultimate outcome will not put stronger buffers against loss into big global banks.

And onto the global scene now burst the Chinese banks, loved by the markets and backed by the state (as seen in this week's [IPO by the Agricultural Bank of China](#)). To be sure, there is a governance structure around these banks that has worked after a fashion within China. But whenever banks go global, they tend to slip outside the domestic constraints that have worked well – remember what happened when [Japanese banks went on a global buying spree in the 1980s](#); this is also a potential issue as [Canadian banks expand internationally](#).

What does this mean for US-based global banks in the aftermath of the Dodd-Frank financial reform bill? Their leading foreign competitors are backed by creditworthy governments, e.g., Germany (and arguably some other eurozone countries) and China. Without question, this provides a form of nontransparent, unfair, and dangerous subsidy to those financial sectors. How do we compete on this basis?

To some degree, of course, we have followed suit – although our government guarantees for Too Big To Fail banks are arguably more hidden and more dangerous than what we see in Europe.

But is this really where we want to be? When hidden subsidies are provided to various nonfinancial sectors in our trading partners, we take that up with the World Trade Organization. Banking has not, until now, been seen in the same terms – the idea was that we could get sufficient convergence through other means, including the Basel Committee.

With the European and Chinese states on course to back their global banks for the indefinite future, this traditional approach increasingly seems unappealing. Either we will play in the same state-backed banking space (and face the dangerous consequences) or we will need to think about the international basis for trade in financial services from a new perspective.

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Bad Software

The Baseline Scenario » 2010 » July 7/9/10 at 3:18 AM James Kwak

By James Kwak

Planet Money did a story this week on the [problems with medical billing](#). This is something I've been vaguely interested in for a long time; nine years ago, we seriously thought about it as a business opportunity for our company.

The Planet Money team said that there is \$7 billion in waste in the medical billing process per year, which sounds like a lot until you realize that it isn't. (Total healthcare costs in the United States are on the order of \$2 trillion, I believe.) But the story had a great example of the problems with enterprise software that I've [written about before](#).

The story comes from Jonathan Bush, CEO of a medical billing outsourcer (they bill insurance companies on behalf of doctors and keep a percentage of the proceeds). It has to do with the codes that one of the Blue Cross/Blue Shield companies requires doctors to use to request reimbursement for a certain injection. The doctors used to submit eight-character codes for the procedure. However, the insurer decided that they wanted to negotiate lower prices for the drug itself from drug manufacturers. To do that, they need data on which manufacturer's drug is used each time a doctor injects it—and that information isn't contained in the eight-character code. So the insurer decided to switch to a different, eleven-character code for the procedure, since the longer code carries information about the drug manufacturer. (Note: this is what we want insurers to do, because it enables them to reduce costs.)

This is already a pain for doctors. But the kicker is that the insurer's computer system only has space for eight characters for this particular code. So the insurer sent all of the doctors it works with a memo explaining how to compress the eleven-character code into an eight-character code.* This involved rules like “drop the first digit if it's a zero, otherwise drop the sixth digit if it's a zero . . .” that are not only a pain but that are sure to spawn enormous numbers of errors.

The underlying problem is a combination of: (a) the way data is stored in mainframe computers; (b) lack of foresight when designing software programs; and (c) difficulty in modifying said programs. (The better solution would have been for the insurer to write a program that did the eleven-to-eight compression automatically—but presumably it batch-loads the data it receives into its mainframe, and there is no staging area where it can do that kind of pre-processing. Or they were just lazy.)

Multiply this problem by a million and you have the state of enterprise software today.

One Paragraph on the Financial Reform Bill

The Baseline Scenario » 2010 » July 7/9/10 at 3:30 AM James Kwak

By James Kwak

From [Mike Konczal](#):

“Examples? Off the top of my head, ones with a paper trail: [Treasury] [fought the Collins amendment](#) for quality of bank capital, [fought leverage requirements](#) like a 15-to-1 cap, [fought prefunding](#) the resolution mechanism, [fought Section 716](#) spinning out swap desks, [removed foreign exchange swaps and introduced end user exemption](#) from derivative language between the Obama white paper and the House Bill, [believed they could have gotten](#) the SAFE Banking Amendment to break up the banks but didn’t try, [pushed against](#) the full Audit the Fed and [encouraged the Scott Brown deal](#).”

(By the way, if you’re missing your financial commentary fix during my self-imposed hiatus, I recommend [Mike’s blog](#) highly—not that that’s news to anyone anymore.)

Yes, I would vote for it if I had a vote. But it’s far from enough. I believe what Rob Johnson says (quoted in Konczal’s post):

“This is the first act of a many act play. Finance was too large in proportion to our economy. It is still too large, and our dysfunctional political system that aided and abetted the growth of the financial sector over the last 20 years cannot be expected to turn on a dime and enact profound and needed change. That agenda is still ahead. This first round was not the whole fight. It was the wake-up call and the beginning of the fight. Rest up and get ready. There is so much more to do.”

Except that I’m not sure if there will be more acts. The incentive for the Republicans is to trash the bill for political purposes but then do nothing significant about it if and when they come to power. (It’s easier politically to rail against government bureaucracy in general than to actually, say, weaken consumer protection.) The incentive for the Democrats is to declare victory; as Barney Frank might have said, you don’t win elections by saying the bill you passed was not very good and you want to be reelected so you can make it better. There is some reasonably small chance that over the next decade we will get a shift in popular opinion away from our decades-old infatuation with finance and our willingness to excuse anything by saying it is good for economic growth (even if it isn’t). But otherwise we’ll need serious campaign finance reform—or another financial crisis—before more significant reform can happen.

The Kanjorski Surprise – Now It Gets Interesting

[The Baseline Scenario](#) » 2010 » July 7/9/10 at 6:06 AM Simon Johnson

By Simon Johnson

The bank lobbyists, it turns out, missed one. They and their congressional allies were able to gut the Volcker Rule, the Lincoln Amendment, and almost everything else that could have had a meaningful effect on the industry.

But, as I point out in a [Bloomberg column today](#), they couldn't get at (or didn't sufficiently understand?) the Kanjorski Amendment. This Amendment was [originally proposed by Congressman Paul Kanjorski](#) (chair of an important House subcommittee on capital markets) during the fall. Against the odds, it survived in the final House bill and now – probably because it has stayed mostly below the radar – remains in the reconciled legislation.

Kanjorski gives federal regulators the power and the responsibility to limit the activities or even break up big banks if they pose a “grave risk” to the financial system.

The Federal Reserve is in the hot seat on this issue – and it needs 7 out of the 10 members of the new systemic risk council to agree to any action. But for the first time someone at the federal level must make a determination regarding whether an individual firm poses system risk.

And congressional committees can call upon the responsible people to explain how they determine whether a megabank is or is not dangerous. What are the risk metrics they use? To what extent do they take on board outside opinions? How much do they consult with the bank itself?

This also creates important space for critics. There are many people – outside of the big banks – working on developing ways of assessing system risk. Again, congressional hearings can raise the prominence and credibility of this work. The question will be: If the regulators are not taking these perspectives into account, why not?

This may all sound rather technical, and to some extent it is. But it is also intensely and pointedly political. The Kanjorski Amendment makes it clear that system risk must be assessed and dealt with. And it assigns clear responsibility for this issue – along with a cut and dried list of remedies.

The debate on big banks and the dangers they pose is far from over.

Why Agencies Get Things Terribly Wrong

[The Baseline Scenario](#) » 2010 » July 7/10/10 at 11:15 AM James Kwak

By James Kwak

There has been a lot of criticism of regulatory agencies in the past couple of years, from the Office of Thrift Supervision and the Securities and Exchange Commission (Madoff who?) to the Minerals

Management Service. But most of the people in these agencies are not evil; on the contrary, I believe (without a ton of evidence in support at the moment) that a majority are conscientious, hard-working, and civic-minded, and a significant minority are actually quite good at what they do. So why do they get things so wrong?

A few days ago, [Leslie Kaufman](#) of The New York Times wrote an article describing how the Fish and Wildlife Service “signed off on the Minerals Management Service’s conclusion that deepwater drilling for oil in the Gulf of Mexico posed no significant risk to wildlife.” This sounds like classic incompetence, or corruption, or both.

But the report itself, it seems, was not so far off, at least in its details. The report assessed spills of up to 15,000 barrels of oil. As Kaufman paraphrases,

“In its 71-page biological assessment, the Minerals Management Service concluded that the chances of oil from a spill larger than 1,000 barrels reaching critical habitat within 10 days could be more than 1 in 4 for the piping plover and the bald eagle, as high as 1 in 6 for the brown pelican and almost 1 in 10 for the Kemp’s ridley sea turtle. When the model was extended to 30 days, the assessment predicted even higher likelihoods of habitat pollution. . . .

“‘Heavily oiled birds are likely to be killed,’ the assessment said.”

Fifty-one days after the well explosion, the amount of oil spilled is probably somewhere between one and three million barrels.

So what happened? Probably two things.

First, someone at MMS decided that they would only model spills of up to 15,000 barrels, even though BP’s permit to drill the well estimated a worst-case scenario of 162,000 barrels per day.

Second, the local FWS office “considered that any likelihood under 50 percent would not be enough to require the protections of [the] office.”

This second decision seems incredibly stupid. After all, why 50 percent? And let’s say you review four reports for four different things, each of which says there is a 25 percent chance of something bad happening. At that point, the chances of something bad happening rise to about 70 percent. You always rule out the possibility of stupidity at your peril. But another possibility is that FWS had been told it could only act in cases where the risk was greater than 50 percent, because some political appointee had decided that that was the meaning of some statute.

In other words, it doesn’t take a lot of meddling to produce these terrible results. One political appointee or middle manager sympathetic to industry sets the parameters of a study. Another political appointee sets the threshold for action. And look what happens.

It's like saying that all regulations have to pass cost-benefit analyses, and then setting the rules for how to do those analyses. (In general, it's much harder to measure the benefits of regulation—because it involves the value of, say, clean air—than the costs of regulation.) Like saying you have to discount future lives at a rate of [7 percent per year](#), which makes it possible to justify putting any amount of toxins into the ground (or the plastic products we eat out of), because the health effects are decades away.

We all know what the results look like.

David Axelrod's Talking Points

The Baseline Scenario » 2010 » July 7/14/10 at 12:47 PM Simon Johnson

By Simon Johnson

David Axelrod was on the [Diane Rehm show this morning](#) – a great opportunity to connect with listeners who will actually stop what they are doing and pay attention, at least for a short while. He was awful.

He had even the most basic facts wrong – it's not “8 million people have lost their jobs” but rather “more than 8 million jobs have been lost” since December 2007. He rambled – it was hard to see his point, particularly in the introduction. But most of all, there was no narrative – why exactly did we have a recession, why has it been so bad, and why aren't the jobs coming back?

Without a narrative, how can anyone make sense of the past 18 months?

Axelrod can choose his narrative – and obviously doesn't need to agree, for example, with the view that the financial system became dangerous and now needs to be reined in – but he has to say something coherent. You can't just make isolated points like “the fiscal stimulus helped” or (even more confusing) “we'll now address the budget deficit.”

There was really no explanation for why the economy has become such a difficult place for so many people. How did we go from apparent prosperity in 2007 to the deepest recession of the past 50 years? And how are we going to get the jobs back?

Blaming things on the Republicans in some vague sense (e.g., tax cuts) also doesn't make sense to people. If you want to get partisan, you have to connect the dots in a convincing manner – otherwise people will (rightly) tune out.

Does the problem here lie with the economic briefing that Axelrod received before going on air? If

so, changing those responsible would be an obvious first step.

But the issue may be deeper – or higher up the administration. It is entirely possible, based on what we are seeing and hearing now, that even Axelrod and other members of the political wing of the White House don't really understand what happened (the big banks blew themselves up) – and why they are now so powerless to do anything about it (after being rescued, the banks fought hard to block effective change). The credit system remains fundamentally damaged and unfixed; this undermines expectations for the future in many ways and slows the recovery of jobs.

The New Antitrust – For Banks

The Baseline Scenario » 2010 » July 7/14/10 at 9:53 PM Simon Johnson

Just over a hundred years ago, the United States led the world in terms of rethinking how big business worked – and when the power of such firms should be constrained. In retrospect, the breakthrough legislation – not just for the US, but also internationally – was the Sherman Antitrust Act of 1890.

The Dodd-Frank Financial Reform Bill, which is about to pass the US Senate, does something similar – and long overdue – for banking.

[To read the rest of this post, [click here](#) - which takes you to Project Syndicate's site; no fees or advertising involved]

The Future of Finance: International Edition

The Baseline Scenario » 2010 » July 7/15/10 at 6:16 AM Simon Johnson

By Simon Johnson

Bankers and hedge fund managers are fond of saying, “if you place restrictions on our activities in New York, we'll just move elsewhere – like London.” This makes attitudes towards the financial sector in other countries – particularly the UK – highly relevant for American public policy debate on this issue.

Is it the case that the new found skepticism about modern finance and its effects on the real economy is confined to the United States? Or is there a broader shift in thinking around the world, including in other leading financial centers?

A new book out this week from the London School of Economics, “The Future of Finance and The Theory That Underpins It”, suggests that a profound shift in the consensus is well underway.

(Disclosure: I have an essay in this book, but as it is [downloadable for free](#), there is no royalty involved.)

The book represents the views of leading UK-based thinkers and policymakers, including [Adair Turner](#) (the outgoing chair of the Financial Services Authority), Martin Wolf (the Financial Times columnist, now a member of the [new UK Commission](#) charged with determining if banks' size and scope should be limited going forward), and [Andrew Haldane](#) (a senior Bank of England official who has been a high profile critic of the financial sector as it is currently organized).

This is obviously a group people who are willing to talk with each other, so some convergence in views is not unexpected. Still, it is striking that a fairly disparate set of officials, academics, and practitioners should find themselves largely now in agreement that we have a problem – the financial sector in the UK (and elsewhere, like the US) has become potentially dangerous.

The benefits from banking, broadly defined, on current scale and with its existing incentive structure are – at best – very limited. In contrast, the costs – both in the recent past and likely future – are large and actually quite frightening. The fiscal position of the UK has been literally ruined by the measures the last government had to put in place to support the big banks, directly and indirectly. Whatever your assessment of the fiscal austerity measures being pushed hard by the new government, there is no question that much of the underlying problem arises from the continuing failure of financial regulation.

This then leads to the bigger question: What exactly should be done? On this point, participants reflect the broader split in opinion. Some prefer “better regulation”, which includes higher capital requirements (if we proceed along traditional lines) and a “macroprudential committee” (if we are to move regulation onto a new basis – creating a structure parallel to the committees that set monetary policy in many leading central banks).

But strengthening regulation is never as easy as it sounds – because the regulated banks get to respond and because more activities will move into relatively unregulated areas. [Charles Goodhart](#), for example, represents responsible thinking along these lines and many of the ideas that he discusses (e.g., on living wills) may be implemented. But how much difference can such arrangements make when the big banks have every incentive to game the system – and when the resources commanded by the regulators are relatively tiny?

The alternative is new institutional arrangements, i.e., a different legal framework for the core of our financial system.

[John Kay](#), also a Financial Times columnist, has been getting traction with his proposals for “narrow

banking” – very much along the lines recently proposed by Paul Volcker. Allow banks to only provide a limited range of essential financial services (around deposit-taking), and regulate those activities tightly. Any other “risk-taking” parts of finance should be completely separated off from the regulated “safe” parts. If that separation could really be effective – and that is the big “if” ([ask Mr. Volcker](#)) – then anything in the “risky” category could safely be allowed to fail, without disrupting the fundamental credit mechanism.

[Martin Wolf](#) prefers to directly control the way in which bankers can be paid – forcing their pocket books to face the consequences tomorrow of poor decisions today. This is appealing in many ways, but also hard to implement. The essence of limited liability – a cornerstone of modern economic development – is that your downside losses are capped. And any attempt to impose unlimited (or even very large) personal financial liability on banking executives could surely be offset through insurance policies, either explicitly (if allowed) or implicitly (through all kinds of hedging transactions – remember these people have access to the fastest traders and best lawyers on the planet).

All this heads in the right direction but does not yet reach a definite conclusion. In the last chapter, [Peter Boone and I](#) argue that we need an international treaty organization – along the lines of the World Trade Organization, but for finance. We have to decide, by mutual agreement, what is and is not allowed in the international exchange of financial services – with a view to making the system dramatically safer.

If that sounds too complicated or not appealing for any reason, consider the implicit liabilities that underpin our current arrangements – and the cases (in our chapter) of countries devastated fiscally by their financial misadventures.

If we continue to allow the free international flows of capital alongside national (and antiquated) regulatory systems, the world’s banking system will get out of control repeatedly. Increasingly, influential people in London and other financial hubs outside the United States begin to see the issue in these terms.

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Tim Geithner’s Ninth Political Life

The Baseline Scenario » 2010 » July 7/15/10 at 8:59 PM Simon Johnson

By Simon Johnson

In modern American life, Treasury Secretary Tim Geithner stands out as amazingly resilient and remarkably lucky – despite presiding over or being deeply involved in a series of political debacles, he has gone from strength to strength. After at least eight improbably bounce backs, he might seem unassailable. But his latest mistake – blocking Elizabeth Warren from heading the new Consumer Financial Protection Bureau – may well prove politically fatal.

Geithner was a junior but key member of the US Treasury team that badly mishandled the early days of the Asian financial crisis in 1997 and received widespread criticism ([Life #1](#)). He was promoted as a result and thereafter enjoyed a meteoric rise.

As President of the New York Federal Reserve from 2003, and de facto head of the government's financial intelligence service, he completely failed to spot the problems developing in and around the country's financial markets; nothing about this embarrassing track record has since stood in his way (Life #2). He subsequently became Hank Paulson's Wall Street point person for one of the most comprehensively bungled bailouts of all time – the Troubled Asset Relief Program, TARP, which in fall 2008 first appalled Congress with its intentions and then wasn't used at all as advertised (Life #3).

TARP and related Bush-Paulson-Geithner efforts were so completely and clearly unsuccessful in October/November 2009 that the crisis worsened and Geithner was offered the job of Treasury Secretary by President-elect Obama; the incoming team felt there was no substitute for "experience". Nevertheless, he almost failed in the confirmation process due to issues related to his taxes (Life #4) and then stumbled badly with his initial public repositioning of the TARP (Life #5), which was going to buy toxic assets again but in a more complicated way (perhaps his most complete and obviously personal political disaster to date).

His next Great Escape was the stress tests in spring 2009 – it turned out, supposedly, that there was really no financial crisis. Most of the big banks really did have enough capital; all that had been missing was the government's endorsement of this fact (this is the story, honest). If this seems too good to be true, look at the mass unemployment still around you and tell me if the financial sector really looks healthy (Life #6).

Life #7 was expended concurrent with the forceful arrival on the financial reform scene of Paul Volcker. The Geithner-Summers "financial reform" package from summer 2009 was weak to start with and weakened further as it was discussed in the House; the entire effort was rudderless. Volcker's new proposals helped rescue the reform and restore momentum – but instead of (appropriately) discrediting the Geithner approach in the eyes of the White House, it actually helped the Treasury Secretary climb new pinnacles of influence. Go figure.

Life #8 is the blatant failure of the Geithner strategy to "just raise capital requirements" as the way to deal with distorted incentives and the tendency to take irresponsible risks at the heart of our financial system. Treasury insisted on "capital first and foremost" throughout the Senate debate this year – combined with their argument that these requirements must be set by regulators through

international negotiation, i.e., not by legislation. But the big banks are chipping away at this entire philosophy daily through their effective lobbying within the opaque Basel process – as one would expect. The latest indications are that capital requirements [will barely be raised in any meaningful sense.](#)

Secretary Geithner likes to say, “Plan beats no plan” and in some positive interpretations this is the secret of his success. But it turns out that he had no plan really – the stress tests were a grand improvisation (ultimately implying scary sized government implicit guarantees), the initial financial reform proposals fizzled (the Volcker rescue was against Geithner’s wishes), and the much vaunted tightening of capital standards is completely illusory (doesn’t anyone in the White House read the newspapers?).

On top of all this, it now appears that Secretary Geithner will oppose Elizabeth Warren becoming the new chief regulator responsible for protecting consumers from defective financial products – despite the fact that she has led the way for this issue, on both intellectual and political fronts, over the past decade. The financial sector has abused many of its customers badly over the past decades. This simply needs to stop.

Throughout the Senate debate on financial reform, Treasury insisted that complex details regarding consumer protection need to be left to regulators – and thus the Geithner team pushed back against many sensible legislative proposals that would have tightened the rules. Treasury also promised – although in a nonbinding way – that the new generation of regulators would be an order of magnitude more effective than those who eviscerated whatever was left of our oversight system during the Bush years.

With his track record of survival, Geithner and his team [apparently feel they can push hard](#) against Elizabeth Warren and give the new consumer protection job to someone closer to their philosophy – which is much more sympathetic to the banking industry.

This would be a bad mistake – trying the patience of already exasperated Congressional Democrats. If the Obama administration can’t even complete the deal they implicitly agreed with Senators over the past months, this will set off a firestorm of protest within the party (and with anyone else who is paying attention).

Financial “reform” is already very weak. If Secretary Geithner gets his way on consumers protection, pretty much all of the Democrats efforts vis-à-vis the financial sector’s treatment of customers have been for naught.

Tim Geithner is sometimes compared to [Talleyrand](#), the French statesman who served the Revolution, Napoleon, and the restored Bourbons – opportunistic and distrusted, but often useful and a great survivor with a brilliant personal career. In the end, of course, no one – including Talleyrand – proves indispensable. And everyone of this sort eventually pushes their luck too far.

If the Democratic leadership really wants to win in the November elections, they should think very hard about the further consequences of Mr. Geithner.

Treasury Makes A Mistake – Claiming They Are Not Blocking Elizabeth Warren

The Baseline Scenario » 2010 » July 7/16/10 at 9:26 PM Simon Johnson

By Simon Johnson

It's one [thing to block Elizabeth Warren](#) from heading the new Consumer Financial Protection Bureau.

It's quite another thing to deny in public, for the record, that any such blocking is going on (e.g., [see this report](#); Michael Barr apparently said something quite similar today).

There is a strong groundswell of opinion on this issue from the left – see [the BoldProgressives petition](#). But the center also feels strongly that, given everything Treasury has said and done over the past few months, it would be a complete travesty not to put the strongest possible regulator in charge of protecting consumers. (See [Ted Kaufman on the NYT's DealBook](#), giving appropriate credit to the SEC, and apply the same points to broader customer issues going forward.)

This can now go only one of two ways.

1. Elizabeth Warren gets the job. Bridges are mended and the White House regains some political capital. Secretary Geithner is weakened slightly but he'll recover.
2. Someone else gets the job, despite Treasury's claims that Elizabeth Warren was not blocked. The deception in this scenario would be nauseating – and completely blatant. "Everyone was considered on their merits" and "the best candidate won" will convince who exactly?

Despite the growing public reaction, outcome #2 is the most likely and the White House needs to understand this, plain and clear – there will be complete and utter revulsion at its handling of financial regulatory reform both on this specific issue and much more broadly. The administration's position in this area is already weak, its achievements remain minimal, its speaking points are lame, and the patience of even well-inclined people is wearing thin.

Failing to appoint Elizabeth Warren would be the straw that breaks the camel's back. It will go down in the history books as a turning point – downwards – for this administration.

By James Kwak

A number of people have asked me what I think about the financial reform bill that was finally passed by the Senate. I don't think I have much to add to what I've said already, but here's one more angle.

“We can't legislate wisdom or passion. We can't legislate competency. All we can do is create the structures and hope that good people will be appointed who will attract other good people.”

That's what Christopher Dodd said about the bill, as quoted by [The New York Times](#). It's become a commonplace observation by now that the reform bill, instead of making structural changes to the financial sector, instead increases regulators' discretionary powers to constrain — or not constrain — the behavior of the industry.

As a result, the success of reform, in the words of its supposed architect, depends on hoping that presidents will appoint good people and that that will be enough to attract people to being regulators.

Senator Dodd should already know how that works out. After all, he was in the Senate when George W. Bush appointed John Dugan, James Gilleran, and Christopher Cox to head the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Securities and Exchange Commission, respectively. And we already know what the Republicans think of financial regulation, given their overwhelming resistance to reform.

We can expect a little better from the Obama administration, which did appoint Gary Gensler to head the CFTC and still might do the obvious thing and appoint Elizabeth Warren to head the new Consumer Financial Protection Board. But still, hoping for a few good people—and hoping that presidents will find and appoint those good people—isn't much of a strategy.

The underlying problem is that the bill doesn't do anything to change the basic balance of power between Wall Street and Washington, which is partly based on the fact that it's a lot better to be a banker than to be a regulator, and the only reason to be a regulator (if you believe in free-market incentives) is so you can then become a banker. As Bill Gross, king of the bond market and no one's populist, said to [The Wall Street Journal](#), “Wall Street still owns Washington. Better to have appointed [Former Federal Reserve Chairman Paul] Volcker ‘Dictator-In-Chief’ than to have let the lobbyists dilute what needed to be done.” (Scroll to the bottom and click through the experts in the “Grading the Bill” feature; thanks to [Larry Doyle](#) for finding the link.) So we're left with hope.

Yes, I'm still sticking to my position that the bill is better than nothing. The alternative was sticking

with the environment that gave us a bloated, predatory financial system and the financial crisis. But it's still a missed opportunity. And over the next couple years, as regulators (lobbyists) write the rules necessary to implement the bill, we'll find out if anything really has changed.

Banking Under the Dodd-Frank Act

The Baseline Scenario » 2010 » July 7/22/10 at 6:33 AM Simon Johnson

By Simon Johnson

President Obama's signing of the financial reform bill yesterday does not end our intense debates over banking – rather it just moves them to a new sphere. Instead of arguing about legislation, the next arena is the action (and perhaps inaction) of regulators.

Those pushing for more effective regulation of the financial system are looking for progress along three potential dimensions. The first two – raising capital standards and appointing new regulators – are the most discussed, but powerful interests are blocking real change. The third – tougher and smarter congressional oversight – holds great promise.

First, on key issues – such as capital standards – there could theoretically be a breakthrough in the so-called Basel Process of international negotiations, e.g., in the run-up to the November G20 summit in Seoul. Some senior US administration officials continue to make bullish off-the-record remarks, but Sheila Bair is [sounding a much more cautionary note](#). And European participants continue to emphasize that Germany does not want a significant increase in capital for its banks.

The baseline view here must be that the “lowest common denominator” approach will prevail. This was the consensus at last week's [Future of Finance meeting in London](#) – not at all encouraging.

Second, the easiest way to signal commitment to real reform would be for the Obama administration to appoint strong new regulators, with the head of the just-created Consumer Financial Protection Bureau representing the most important symbol of any new reality.

The front-runner for this job has long been Elizabeth Warren – distinguished Harvard law professor, [chair of the congressional oversight panel for TARP](#) (the Troubled Assets Relief Program), and thorn in the side of financial companies with abusive practices. In fact, there are many people who supported the banking reforms under the assumption that Professor Warren would get this job – and start the new agency down the right road.

Unfortunately, in remarks earlier this week, Senator Dodd – the outgoing but still powerful chair of the Senate Banking Committee – appeared to rule out Warren. [His wording was indirect](#) – implying

that she could not be confirmed – but his meaning was clear.

The statement was all the more striking because Warren enjoys a good relationship with leading Republicans, in part because they like her toughness in the TARP oversight role. For example, Senators Bennett and Corker – both members of the Senate Banking Committee – praised her work last September, and Senators Snowe and Grassley have also been supportive in the past. The initiative to block Warren [appears to be coming largely from figures on the Democratic side.](#)

All of this suggests it would be excessively optimistic to presume that more effective people brought in to run regulatory agencies any time soon.

The final way in which regulation could actually make progress would be through continued congressional pressure. It is slightly too early to discern the exact contours of what may be possible, but early discussion suggest we will see established a series of revealing oversight hearings in both the House and the Senate.

Just as the chairman of the Federal Reserve Board appears at regular intervals to explain and elaborate on monetary policy, the chair of the Systemic Risk Council (i.e., the Treasury Secretary) may soon be appearing to discuss the level and determinants of risk in the global financial system. This is a central concept for [the Kajorski Amendment](#), the radical language within the Dodd-Frank Wall Street Reform and Consumer Protection Act that gives regulators the right and the responsibility to break up big banks when they pose a “grave risk” to the financial system.

Such congressional hearings could become a vague or meaningless discussion, of course. But the early indications are that there is likely to also be a great deal of substance, e.g., about [new methodologies](#), global developments ([such as in China](#)), and even incidents when major firms with “state-of-the-art” risk management systems manage to lose a great deal of money (e.g., as with [Goldman Sachs’ equity trading in the last quarter](#)).

For a foreshadowing of the discussions to come, take a look at [the hearing this week](#) of the Subcommittee on Investigations and Oversight for the House Committee on Science and Technology. The focus was on macro models (e.g., start with [Robert Solow’s remarks](#); he is always clear and to the point), but you can see where this is going.

Smart members of Congress will do very well for their constituents – and for themselves – if they pursue these analytical issues hard. No one is happy to just “leave it to the experts” in the Fed or the Treasury – let along the private sector, particularly big banks.

The most cherished notion of Alan Greenspan was probably that the private financial sector will figure things out, and should be left alone as much as possible. It is hard to find anyone today who takes this view seriously.

The issue now is to find legitimate and effective means of congressional oversight, pushing

regulators hard to do the right thing: Question Everything.

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

Yet Another Reason to Like Elizabeth Warren

The Baseline Scenario » 2010 » July 7/28/10 at 12:30 AM James Kwak

By James Kwak

[Bob Lawless](#) points me to this [2006 blog post](#) by Elizabeth Warren. Warren describes a first-year contracts class on the case that upheld a fine-print forum selection clause (a clause saying that if you want to sue us, you have to sue us in X jurisdiction—Florida, in this case) on the back of a cruise ship ticket.

Warren's entire class (Harvard, let me say for the record) insists that, as a *factual* matter, this decision is good for consumers because . . . well, regular readers of this blog should be able to fill in stock Mickey Mouse economicistic hand-waving as well as any first-year law school student. Of course! Forcing people to sue in Florida (or to accept binding arbitration in the forum of the company's choice) deters frivolous lawsuits and lowers costs for the company, and it can pass those savings onto consumers. Why does it pass those savings onto consumers instead of putting them into shareholders' (or managers') pockets? Because in a perfect competitive market, if Alpha Cruise Lines doesn't, then Beta Cruise Lines will, and Beta will underprice Alpha, . . . Consumers will read the fine print and can make an informed choice between the lower price with the forum selection clause and the higher price without the forum selection clause.

Anyway, this is what Warren's post is about—how people think that logical inferences from unrealistic assumptions somehow produce “facts.” And it isn't just first-year law students. I'm reminded of Frank Easterbrook of the Seventh Circuit asserting that sophisticated investors ensure that prices are set rationally, protecting unsophisticated investors—on the basis of a [single, purely theoretical law review article](#) (those in the legal world will appreciate the italics).

This is, in a nutshell, why the field of economics has been able to do so much damage in just a few decades—at the same time that economic thinking itself has become much richer (think Akerlof, Stiglitz, Kahneman and Tversky, Ariely, Levitt-Wolfers-Ayres-Donohue, Duflo, etc.) and probably better as well.

I'd like to say that Yale is better, but my contracts class had its own Mickey Mouse economics as well—which I felt compelled to respond to [here](#). (Actually, Yale *is* better—just not along that particular

dimension.)

Required Intellectual Capital

The Baseline Scenario » 2010 » July

7/29/10 at 6:07 AM

Simon Johnson

By Simon Johnson

At one level, the pursuit of higher and more robust capital requirements for banks is not going well. [The US Treasury insisted](#), throughout the year-long financial reform debate, that capital should be the focus – increasing the loss-absorbing buffers that banks must carry – and that they (and other regulators) needed to negotiate this is through the Basel Committee process.

But Basel has some under great pressure from the banking lobby, which argues that any increase in capital requirements would limit lending and slow global growth (see this [useful background by Doug Elliott](#)). The Institute of International Finance (IIF) – a lobby group for big banks – issued [an influential “report”](#) along these lines and the European stress test results strongly suggest that Euroland politicians do not want to press more capital into their financial system – “just enough” would be fine with them.

However, at another level – in terms of the analytical consensus around these issues – there is a great deal of progress in the right direction. In particular, [an important new paper](#) by Samuel Hanson, Anil Kashyap, and Jeremy Stein, “A Macroprudential Approach to Financial Regulation” pulls together the best recent thinking and makes three essential points. (This is a nontechnical paper written for the *Journal of Economic Perspectives* – it’s a “must read” for anyone interested in financial sector issues but requires some effort and a little jargon does creep in.)

First, if we are really to apply the much discussed new “macroprudential” approach to regulation, we need to get much more serious about capital requirements. In the past, regulators only cared if each bank – by itself – had enough capital to withstand likely losses. But experience over the past few years has made it completely clear that this is not enough.

The “macroprudential” view, articulated nicely here, is that we should worry about banks being forced to dump assets in order to reduce their balance sheet – capital requirements are usually stated as the ratio of “capital” (ideally this would be shareholder equity; [this link provides more detail](#)) to total assets. Forced sales can cause asset prices to decline sharply – feeding into exactly the problems we saw in 2007-08, and eventually leading to the near complete collapse of the market for asset backed securities.

Individual financial institutions, however, do not care enough about the systemic effects of their

actions – these costs are “externalities” to their decision-making. But from a social point of view this is a big deal and an important reason why the recession of 2008-10 was so severe. We should therefore have substantially higher capital requirements than heretofore – presumably far above what regulators currently have in mind.

Second, we should really set capital requirements for types of assets not – as is done currently – by types of lenders. Banks obviously have an incentive to “leverage up”, meaning to borrow more relative to their equity. If we regulate banks, these same transactions will migrate to other more shadowy parts of the financial system.

Probably the most innovative part of authors’ proposals is that we should set higher margin requirements against asset-backed securities. Allowing anyone – irrespective of what you call them – to borrow heavily against such assets is simply not a good idea. Unfortunately, this approach is completely absent from the current regulatory reform toolkit.

Third and perhaps most important for the continuing policy debate, the authors are quite clear: There is no evidence that increasing capital requirements – if handled in the right way – would have significant adverse effects on credit available to the nonfinancial sector or on economic growth and employment.

The policymaker consensus is unfortunately in a different place on this – unduly swayed by the IIF and other representatives of global banks. But Hanson, Kashyap, and Stein are careful and categorical – shifting from debt towards more equity financing for banks would have, at most, a small effect on interest rates for loans. The IIF and its allies are plainly and obviously wrong on this issue.

The authors are leading financial experts and, as a result, carry a great deal of weight in policy circles. [Stein is a professor at Harvard](#), former president of the American Finance Association and a sometime adviser to the Obama administration. [Kashyap is a professor at Chicago](#), and has written [authoritatively on the financial rise and fall of Japan](#), among other things. [Samuel Hanson](#) is an up-and-coming graduate student at Harvard.

They do not in this paper spend much time explicitly on the political economy of capital requirements and the broader regulatory framework for banks in the US or around the world. But implicit in their analysis is the sensible idea that banks and other powerful financial players are not passive “rule takers” – the finance industry has spent a great deal of time and treasure in recent decades undermining what these authors would regard as sensible rules.

And the same global banks are working hard to undermine the Basel process, [so far to great effect](#). Hanson, Kashyap, and Stein have helped move our thinking in the right direction. But the stark contrast between their views and the political/regulatory reality on the ground only highlights how much further we need to go.

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