The Tilted Playing Field

The Baseline Scenario » 2010 » August 8/2/10 at 10:50 AM James Kwak

By James Kwak

It's been widely noted that financial reform is now entering a new phase as the action moves from Congress to the regulatory agencies that will write the hundreds of rules necessary to implement the reforms. During the congressional fight, the financial sector had a huge advantage in money and lobbyists, but we had one advantage: the fact that there was (from time to time) a lot of media coverage, and Congressmen care at least a little about public opinion.

In the rule-writing phase, the banks still have a huge advantage in money, lobbyists, and lawyers– and are [hiring as many ex-regulators as they can]to press their case. As our friend Jennifer Taub writes at [The Pareto Commons]:

> What lies ahead, over the next year and beyond, will require far larger armies of lawyers, economists, finance experts and just plain able bodies and minds to monitor and influence the rulemaking process. Rumor has it that one bank alone plans to set up 100 teams of employees, tasked with particular rule makings. And that is just one bank.

Unfortunately, however, the pressure of the public spotlight is largely off, tilting the battlefield in favor of industry.

Our best hope is that the people in the regulatory agencies really do want to do the right thing, which is quite possible for people like Gary Gensler and Sheila Bair, and soon we'll have John Dugan out of the OCC. This is a big reason why we don't need neutral arbiters as the heads of these regulatory agencies–we need real advocates who will take the side of ordinary people and the real economy against a financial sector that is still too big and too predatory.

Yes, this is code for Elizabeth Warren, but it's not just about Elizabeth Warren. The regulators in all these agencies should realize that they are going to spend the next two years fighting *against* the Wall Street banks and their legions of lobbyists. If they do their jobs right, they will never work in the financial sector again (except maybe at a hedge fund or a buy-side investment consultancy). And if they're not up for that fight, we need someone else who is.

Health Care Non-Solutions

The Baseline Scenario » 2010 » August 8/4/10 at 5:30 PM James Kwak

By James Kwak

[Ezra Klein] makes an important point about our nation's health care problem: it's not just a government deficit problem. The underlying problem is that health care costs are not only growing faster than prices (inflation), but also faster than GDP (economic growth), and as a result the amount of stuff we as a nation will be able to afford, other than health care, will start to go *down* at some point in the future. (Picture originally from Joseph Newhouse in Health Affairs.)

This means that proposals to solve the long-term budget deficit problem by cutting Medicare benefits are not solutions: they simply shift the problem from the government to individuals–which means they shift the problem from us as taxpayers to us as old people or us as family members of old people.* If, for example, we increase the eligibility age for Medicare from 65 to 67, the government saves money, but only because people who are 65 and 66 lose money–or, alternatively, all of us lose money because their employers now have to pay more for health care.

Paul Ryan's non-solution is a perfect example. By converting Medicare to a voucher program, he would insulate the federal government from health care cost inflation, saving money for taxpayers; but at the exact same time, this would expose old people even more to health care cost inflation, increasing costs for them and their families. Does Paul Ryan think that somehow "taxpayers" are different from "old people and their families"? Yet his proposal refuses to go away, my efforts notwithstanding. (And despite the fact that his proposal doesn't actually reduce the deficit–it makes it worse–as Brad DeLong reminds us.)

* Yes, I know the argument that by shifting costs from the government to households, we reduce the incentives to over-consume health care. But if that's your argument, then you have to explain how the private sector is better at managing health care costs than the government, and it isn't. There are a lot of reasons for this, but the simplest is that in either case spending is mediated by an insurer (Medicare on the one hand, private insurers on the other), and Medicare has more market power than any private insurer.

The Treasury Position – On The Volcker Rule

The Baseline Scenario » 2010 » August 8/5/10 at 7:34 AM Simon Johnson

Former Secretary of State George Shultz famously quipped about Washington: "Nothing ever gets settled in this town. You have to keep fighting, every inch of the way." This is proving just as true for banking reform as for other aspects of American government policy.

For example, Senators Carl Levin of Michigan and Jeff Merkley of Oregon, after considerable effort, were able to place strong language in the Dodd-Frank financial-sector legislation – enacting a version of the "Volcker Rule" that would require big banks to become significantly less risky. While this idea originated with Paul Volcker, the former Fed chairman and senior adviser to President Obama, and was announced with great fanfare by the president himself in January, it was clear – from the beginning and throughout the detailed negotiations this spring – that the Treasury Department was less than fully enthusiastic about this approach.

Treasury's position – ranging from lukewarm support to outright opposition at times – created an uphill task for Senators Levin and Merkley. And now that they have reached the top of the Dodd-Frank hill, what do they see? Another even steeper climb awaits, because the Treasury Department is digging in publicly against the drafting of detailed regulatory rules that would actually make Volcker-Levin-Merkley effective.

In a strongly worded letter to regulators, released on Tuesday, the two senators laid out in some detail exactly what the law requires – and they are tough and quite specific on reducing conflicts of interest, limiting proprietary trading and ensuring that market-making doesn't become a hidden way for banks to take huge risks. Just in case there is any doubt about the legislative intent, the senators forwarded their colloquy from the Congressional Record – an exchange on the Senate floor in which they, as drafters for this part of the legislation, made the intent as clear as possible. This is the entire Congressional discussion on the specifics for this part of the legislation, and the Senators have made it easy for any judge in the future to determine what they really wanted to achieve.

Treasury Secretary Timothy Geithner made his view on these issues quite clear in a major speech at New York University on Monday, and it would be an understatement to say he is not in complete agreement with Volcker-Merkley-Levin. Mr. Geithner's theme sounded reasonable enough – "maintaining a balance" between curtailing financial excess and benefiting from financial innovation. But if you look carefully at the details, you understand why so many pro-reform people behind the scenes are becoming increasingly frustrated with Mr. Geithner's philosophy.

Amazingly, Mr. Geithner made no reference to the Volcker Rule, either explicitly or even implicitly – despite the centrality of this idea to the recent debate. It appears to be nowhere at all in his list of priorities (or on the "to do" list of Michael Barr, the responsible Assistant Secretary, who gave a follow-up speech on Wednesday). He is apparently signaling to all the regulators involved that this is not a top priority for the administration and – presumably – they should toe this line if they would like to be reappointed. Treasury carries great weight on these issues, even with nominally independent regulators, and in the Treasury interpretation big banks would be allowed to rearrange their activities so they can still effectively take big risks – earning big returns in good times and creating major problems for the rest of us when the cycle next turns down.

Mr. Geithner is insisting, as he did throughout the Congressional negotiations, that all the weight should be placed on increasing capital and improving its quality. This is not objectionable as one element of a reform strategy, but it still looks very much like putting all our eggs in one dubious basket – one that has failed us repeatedly before.

The latest details on the international negotiations for higher capital requirements – to which Mr. Geithner continually defers – are not any more encouraging. All the indications from the so-called Basel 3 process are that banks are fighting back hard against having to hold substantially stronger buffers against future losses. The Treasury may not have conceded all the ground on this issue, but it is in retreat – with the Secretary insisting on Tuesday that raising capital requirements could damage growth, despite all the evidence to the contrary (reviewed here last week).

Given this context, we should worry and wonder about the "financial innovation" to which the secretary alludes. Again, this sounds good in principle, but in practice the benefits are elusive, if not illusory – other than for people in privileged positions within the financial sector. Mr. Geithner wants the financial sector to be able to take more risk – but to what end, from the point of view of society as a whole?

Mr. Shultz is also reported to have said: "I learned in business that you had to be very careful when you told somebody that's working for you to do something, because the chances were very high he'd do it. In government, you don't have to worry about that." For all our sakes, let us hope Congress fights hard to prevent important parts of the Dodd-Frank bill from falling into the abyss of regulatory inaction and inattention – the place that just brought us the greatest recession since World War II.

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It's Hard To Take The Fiscal Hawks Seriously: Testimony To The Senate Budget Committee

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

By Simon Johnson

Most of the discussion of federal budget issues today is misdirected. The shorter run issues are dominated by the likelihood of another financial crisis – and the implications that would have for the budget deficit – but no "fiscal hawks" even want to acknowledge the issue. It is very hard to take anyone seriously if they refuse to look at these (uncontroversial) numbers. Medium term, we obviously need tax reform. The good news, in a sense, is that the US has an antiquated and inefficient tax system; it would not be hard to improve how this operates, raising revenue and actually reducing distortion. Longer term, Medicare is obviously a tough problem with no easy solutions yet in sight. But the argument "just cut entitlements" cannot be taken seriously.

Below is my testimony this week to the Senate Budget Committee on these issues. (This link is to a pdf version; also see this page for my testimony to congressional committees over the past 2 years).

Testimony to Senate Budget Committee, hearing on "A Status Report on the U.S. Economy", 10am Tuesday, August 3rd (embargoed until the hearing starts).

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of http://BaselineScenario.com.[1] [Numbered links are to footnotes, at the end of this testimony.]

A. Short-term Prospects

1) The global economy continues to improve, although at a disappointing pace. Sharp recessions traditionally produce rapid recoveries, but the damage wrought by the disruption of global credit in fall 2008 is far in excess of anything we have seen since the 1930s. This could be the slowest recovery of the post-war period.[2]

2) Global growth, Q4-on-Q4, as measured by the International Monetary Fund was 3 percent in 2008 and, based on the latest revisions, will be probably prove to have been under 2 percent in 2009 – the worst performance since World War II. This same measure of growth around the world, which uses purchasing power parity weights, is likely to be somewhat under 4 percent for 2010 but should pick up in 2011.

3) The major risk faced by the world economy is not stagnation year-in and year-out, but rather an unstable credit cycle that produces apparent "growth" – perhaps even high recorded growth – in some years for the United States, but then leads to financial crisis, repeated recession, and very little by way of sustained growth. US GDP in real terms is currently at about the same level now as it was in 2006. (Real GDP, annualized, was around $12.9 trillion in the first quarter of 2006 and $13.2 trillion in the second quarter of 2010; see Table 3B in the July 2010 BEA report).[3]

4) Japan's lost decade in the 1990s was not a sequence of years with zero growth – there were notable expansions and contractions, with high rates of growth in particular quarters and even some years when it seemed that the corner had been turned. Lost decades are evident only in retrospect. The US is currently on track for "losing" at least half a decade of growth (from the beginning of 2006 through the end of 2010).

5) The latest iteration of the unstable global credit cycle has done lasting damage to the United States. This is manifest in the following ways:

a) Long-term unemployment results in skill losses and lower productivity in the future. This undermines future growth prospects and it may shift up the "natural" rate of unemployment. So-called hysteresis in unemployment – meaning that it goes up fast but comes down slowly and not fully – has very much been a feature in the experience of other industrialized countries during recent decades. This is potentially now a major issue for the United States.

b) The credit disruption of 2008-09 is having a persistent impact on hiring decisions in the United States and Europe. Business equipment spending is recovering fast but firms are reluctant to add workers. Most of this uncertainty is due to firms not knowing if they will have consistent access to external financing. As a result, large nonfinancial firms are likely to carry less debt and more cash.

c) The damage to household balance sheets from the boom-bust in real estate will also likely persist; for example, the percent of homeowners with negative equity has stabilized, around 20 percent, but moved down only slightly over the past year. We should expect US households to save move as consequence and the personal savings rate is now around 6 percent of personal disposable income (compared with 3 percent during the early 2000s and closer to 2 percent in the run up to the crisis). This is a pattern we have seen in "balance sheet"-related recessions elsewhere.

d) There is a serious sovereign debt crisis in Europe. While the prospect of default by a eurozone country is not imminent, there is a shift to fiscal austerity across that continent, thus slowing growth further. Structural issues within the eurozone are unlikely to be resolved quickly, thus weakening the euro and limiting the potential for US exports. Resulting financial market instability can also still spread quickly to the US.

e) The financial crisis and its aftermath damaged US prestige and capacity for leadership around the world.

6) It is hard to provide effective stimulus to the US economy in this situation. The longer term budget needs credible consolidation, which is mostly about reforming Medicare and implementing meaningful tax reform (see section C below). These are not difficult in technical terms but the potential for a political impasse threatens long-term interest rates – depending on exactly how the post-crisis adjustment process plays out in other major economies, as this affects relative demand for US government debt. Over the shorter term – i.e., the next decade or so – high levels of systemic risk in the financial sector continue to generate large contingent fiscal liabilities (section B below).

B. Contingent Liabilities from the Financial Sector

1) The scale and severity of the recent recession was due to the nature of excessive risk-taking at the heart of the world's financial system, in the United States and Western Europe.[4]

2) A series of efforts are underway to change the behavior of major global banks and to prevent them from loading up on risks during the next cycle. These are unlikely to succeed. As Jamie Dimon, CEO of JP Morgan Chase remarked in January 2010, "[a financial crisis is] the type of thing that happens every five, ten, seven, years" – and another crisis within that time frame should not surprise us.[5]

3) To see the fiscal impact of the finance-induced recession, look at changes in the CBO's baseline projections over time. In January 2008, the CBO projected that total government debt in private hands—the best measure of what the government owes—would fall to $5.1 trillion by 2018 (23% of GDP). As of January 2010, the CBO now projects that over the next eight years debt will rise to $13.7 trillion (over 65% of GDP)—a difference of $8.6 trillion.

4) Most of this fiscal impact is not due to the Troubled Assets Relief Program – and definitely not due to the part of that program which injected capital into failing banks. Of the change in CBO baseline, 57% is due to decreased tax revenues resulting from the financial crisis and recession; 17% is due to increases in discretionary spending, much of it the stimulus package necessitated by the financial crisis; and another 14% is due to increased interest payments on the debt – because we now have more debt.[6]

5) In effect, a dangerous financial system – prone to major collapses – creates a hidden contingent liability for the federal budget in the United States.

6) The Dodd-Frank financial reforms of 2010 are a modest step towards making the financial system safer, but these are unlikely to solve the problem of systemic risk. By all accounts, the internationally coordinated process of raising capital standards – and thus creating greater shareholder buffers against losses – is not making much progress; there will be little real change, much delay in implementation, and far too much "low quality" capital at the end of the day.[7]

7) As long as massive financial institutions continue to take on huge amounts of risk, there remains a strong possibility that governments in the US and other countries will once again face unexpected liabilities and collapsing tax revenues in a financial crisis – pushing up debt by another 40% or so of GDP.

8) Discussion of this risk was largely absent from the recent debate on financial reform and is not currently quantified by the Congressional Budget Office.[8]

9) In this regard, the IMF's first ever detailed assessment of the US financial sector (known as a FSAP), released last week, is not reassuring. Our financial system remains undercapitalized, according to the – rather mild – stress tests reported there. The veiled warning in this report is that the US faces severe fiscal risks going forward, arising directly from our continued inability to rein in the dangers posed by the financial sector.

C. Risks of a Fiscal Crisis

1) Seen in a comparative perspective, our budget issues are serious but not severe and – relative to other industrialized countries currently under pressure – we have plenty of time to deal with them. Fears of an immediate budget crisis in the United States should not be exaggerated, although we do need fiscal consolidation over the next decade – a combination of tax reform and changes to future Medicare spending.

2) Most other industrialized countries also have to engage in a process of fiscal adjustment and for similar reasons.[9] Compared with other countries at roughly our income level and with similar

demographics, the United States has a major advantage in the sense that we collect relatively little in taxes; in addition, our tax system is relatively antiquated and would benefit from modernization. Using the IMF's numbers – which are for "general government" (i.e., the entire government sector, including federal, state, and local) – the US collected 31.8 percent of GDP in 2000 (compared with the UK at 38 percent, Germany at 46 percent, and France at 50 percent).[10] In both 2009 and 2010 the US collected 30.4 percent of GDP; over the cycle, our revenue relative to other leading industrialized countries remains about the same.

3) Under the CBO's "alternative fiscal scenario," which includes policy changes that are politically likely, government debt in private hands will grow to 185 percent of GDP by 2035 as Social Security, Medicare, Medicaid, and other health care programs grow to consume almost all tax revenues. This should not be a surprise: in 2000, the CBO already projected that these programs would grow to over 16 percent of GDP by 2040—a figure virtually identical to current estimates. This was predictable because it rested on two simple trends: changing demographics and, more importantly, high health care cost inflation.

4) For some commentators, the only possible response for the US is immediate austerity; this is the course being taken in the United Kingdom and parts of the Eurozone. If we continue to spend, the argument goes, markets will lose faith in our ability to repay our debts, interest rates will skyrocket, the dollar will collapse, and our way of life will be at an end. While this argument is plausible in the abstract, there is no reason for panic or precipitate action *now*.

5) The US Treasury Department can currently borrow money at historically *low* interest rates. Investors around the world like saving in a safe currency, the dollar has traditionally been seen as the safest of currencies, and recent developments in Europe and the rest of the world have done nothing to change that.

6) It is true that markets can suddenly lose confidence in a country, with severe economic repercussions. But there is no magical threshold that suddenly makes a country a poor credit risk; Japan's net government debt relative to its economy is roughly at Greek levels, yet Japan can still borrow money cheaply. A country's ability to borrow is determined by its economic fundamentals, its position in the international economy, and the credibility of its political system – relative to other systems.

7) While an extra dollar of spending today is an extra dollar (plus interest) of debt later, what really matters are policies that affect taxes or spending year after year. By contrast, $34 billion for extended unemployment benefits—a temporary program that will become smaller as unemployment falls—has no appreciable impact on our structural deficit.

8) The things that do matter are taxes and entitlements. Therefore, the upcoming debate over the Bush tax cuts is of real importance. According to the CBO, extending the Bush tax cuts would add $2.3 trillion to the total 2018 debt. The single biggest step our government could take this year to address our structural deficit would be to let the tax cuts expire. Such a credible commitment to fiscal consolidation should reduce interest rates today, helping to stimulate the economy.

9) Critics say that this amounts to increasing taxes at a time of high unemployment, and instead the tax cuts should be extended as a stimulus measure. This overlooks the fact that tax cuts are an inefficient form of stimulus, because many people choose to save their additional income instead of spending it. If the goal is to boost growth and employment immediately, it would be better to let the tax cuts expire and dedicate some of the increased revenue to real stimulus programs. Alternatively, if some tax cuts are extended, there should be provisions to eliminate them automatically when unemployment falls to a preset level.

10) Complete elimination of the Bush tax cuts is highly improbable. The most likely outcome is that the tax cuts will be extended for families making less than $250,000 per year.

11) Additional tax revenues will also be necessary in the medium term, and at least three plausible ideas are on the table.

a) The first is comprehensive tax reform, to better align our tax policy with desirable economic incentives. We should consider the value-added tax (VAT) favored by Greg Mankiw (former chair of the Council of Economic Advisers under President George W. Bush), among others. A VAT is a tax on consumption, and therefore could reduce the overconsumption that helped feed the recent credit bubble, encouraging savings and investment instead. Although a simple VAT is regressive, it can be made progressive by combining it with a partial rebate or by exempting necessities. Also, as Martin Feldstein and Len Burman have suggested, we should look hard at tax breaks that act like hidden spending programs. One place to start is the mortgage interest tax deduction, currently available on mortgages up to $1 million, which is part of our excessive package of incentives to buy houses—a policy eschewed by most other industrialized countries.

b) The second is carbon pricing, whether auctioning emissions allocations or taxing carbon directly, at rates that start low and rise over the next decades. Politically speaking, it would be easier to pass a carbon pricing bill by rebating the proceeds back to households (or handing them to energy companies in exchange for political support). But given the large potential revenues from carbon pricing, it would make sense to dedicate a portion to cushion the impact of higher energy prices on the poor, while applying the rest to our fiscal balance.

c) The third is a tax on the financial sector, in the form of a Financial Activities Tax on big banks that enjoy implicit government guarantees. This tax would aim to eliminate the funding advantage that large banks enjoy over their smaller competitors and limit the incentive for big banks to become even bigger. As the International Monetary Fund has argued, across the G20 this would help constrain the worst features of our financial system and reduce the competitive distortions created by the megabanks.

12) After taxes, there is the issue of entitlements—which is mainly an issue of health care costs. According to the CBO's alternative fiscal scenario, growth in Social Security is comparatively modest, from 4.8 percent of GDP in 2010 to 6.2 percent in 2035. A relatively small change in the parameters of this program could lower its future costs, as was done in the 1980s. At the same time, however, Medicare, Medicaid, and other health care programs will more than double from 4.5 percent to 10.9 percent of GDP.

13) There are two ways to reduce the government's health care outlays: reduce the *amount* of health care the government buys or reduce the *cost* of health care. The simplest solution is to mandate that the government buy less health care—by raising the eligibility age for Medicare, capping benefits for high-income beneficiaries, etc. The problem with this approach, however, is that Medicare is not particularly generous to begin with (hence the market for Medigap supplemental policies). In addition, the rest of the nation's health care system is also in sorry straits; if Medicare were to increase its eligibility age, it would simply push people back onto their employers, resulting in higher health care costs for all working people.

14) In other words, cutting Medicare expenses shifts costs from the government onto individuals, many of whom will simply go without decent health care. If we fail in our attempts to control health care cost inflation, this may be the only option. But the better solution is to figure out how to reduce health care costs.

15) A top priority should be to preserve and expand the cost-cutting provisions in this year's Affordable Care Act (ACA). Another obvious step to consider is phasing out the tax exclusion for employer-sponsored health plans, which will not only increase revenue but also end the distorting effects of employer subsidization of health care.

16) Reshaping our health care system to focus on successful outcomes and quality of life, rather than on employing the newest and most expensive technology, is a challenge for which no one yet has a proven solution. But it remains, more than any other single factor, the key to long-term fiscal sustainability.

17) Fixing our long-term fiscal problems will not be easy. But there is no need to panic. And there is no shortage of possible solutions.

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Footnotes below here

[1] This testimony draws on joint work with James Kwak, including *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown* (Pantheon, March 2010) and "The Quiet Coup" (*The Atlantic*, April, 2009), and Peter Boone, including "The Next Financial Crisis: It's Coming and We Just Made It Worse" (*The New Republic*, September 8, 2009) and "Will the Politics of Moral Hazard Sink Us Again" (Chapter 10, in The Future of Finance, July 2010). Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com, where we also provide daily updates and detailed policy assessments for the global economy.

[2] The current recovery is definitely slower than what followed the severe recessions of 1973-75 and 1981-82. Based on actual performance so far and projected growth through end of 2011 from a range of forecasters, the recovery of 2009-2011 might prove a little stronger than the recoveries experienced after the mild recessions of 1990-91 and 2001. See Mike Mussa's influential work for

more discussion (April 2009; April 2010 versions); his latest global GDP forecast is 4.5 percent (using the same definition for global GDP as the IMF).

[3] Details of the advance US GDP estimate for the second quarter of 2010 are from the BEA website. This estimate is notoriously noisy and prone to revision.

[4] We cover this issue in detail in *13 Bankers*.

[5] In his memoir, Hank Paulson makes a statement about the frequency of crises very much along the lines of Mr. Dimon. Larry Summers, in his 2000 Ely Lecture to the American Economic Association, uses similar language.

[6] See also the May 2010 edition of the IMF's cross-country fiscal monitor for comparable data from other industrialized countries, http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf. The box on debt dynamics shows that mostly these are due to the recession; fiscal stimulus only accounts for 1/10 of the increase in debt in advanced G20 countries. Table 4 in that report compares support by the government for the financial sector across leading countries; the US provided more capital injection (as a percent of GDP) but lower guarantees relative to Europe.

[7] For a broader discussion of capital requirements and the state of play in the Basel III negotiations, see http://baselinescenario.com/2010/07/29/required-intellectual-capital/.

[8] The CBO routinely assesses the budget impact of other contingent liabilities, including future health care costs and the likely cost of US commitments to the International Monetary Fund.

[9] See Table 6 in the IMF's May 2010 Fiscal Monitor for budget deficit financing needs across advanced countries (http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf). The US has relatively short maturity debt (4.4 years by this measure), but it is broadly comparable with other industrialized nations on this and other deficit measures. Table 11 in the same report provides estimates of effects from raising revenue in various sources across the advanced G20 economies. Again, the US is in the middle of the pack – there is nothing unusually difficult (on paper) about the adjustment required.

[10] Statistical table 5 in the IMF's May 2010 Fiscal Monitor has general government revenue as a percent of GDP since 2000 and forecast through 2015.

Why Won't "Fiscal Hawks" Discuss The Real Issues?

The Baseline Scenario » 2010 » August 8/12/10 at 7:15 AM Simon Johnson

By Simon Johnson and James Kwak

During this hot summer of fitful economic growth, high unemployment and an oil slick visible from space, Washington is obsessed with…deficits. The resurgence of this periodic fascination is not entirely surprising, given our historically large current deficits. According to the Congressional Budget Office, the 2010 deficit will come in at $1.3 trillion, almost 10 percent of our gross domestic product and, along with the deficit of 2009, the highest level since World War II.

Imminent fiscal collapse has even become a theme for literary novelists – in Gary Shteyngart's "Super Sad True Love Story," American fiscal policy has become a bad joke and the Chinese threaten to stop buying our government debt. And the overextension of government is again a big theme; sales of Ayn Rand's "Atlas Shrugged" are up sharply, although the book was first published more than 50 years ago (it is in and out of the Top 100 list on Amazon).

Deficit fears do have a real foundation. But it is not, as some assume, simply that government spending is out of control. Our current deficits result from the recent financial crisis and recession, and they will recede as the economy recovers. But the federal government also faces a long-term, structural gap between its revenues and its spending commitments – a gap due to policies established decades ago.

To see where our current deficits come from, we need only look at the budget office's baseline projections. In January 2008, the budget office projected that total government debt in private hands – the best measure of what the government owes – would fall to $5.1 trillion by 2018 (23 percent of GDP). As of January 2010, the budget office now projects that debt will rise to $13.7 trillion (more than 65 percent of GDP) – a difference of $8.6 trillion. Of this change, 57 percent is due to decreased tax revenues resulting from the financial crisis and recession; 17 percent from increases in discretionary spending, much of it the stimulus package necessitated by the financial crisis; and another 14 percent to increased interest payments on the debt – because we now have more debt.

The lessons are obvious. First, we need to restore the economy to healthy growth. Here the latest news is mildly encouraging – the world economy is growing, although not as fast as we would like. But the financial crisis will leave a scar on our economy. Long-term unemployment will permanently reduce the skills of too many workers, cutting productivity and increasing spending on the social safety net.

Second, we need to protect our economy from the next financial crisis. The Dodd-Frank financial reform act is a modest step in that direction, but it is unlikely to solve the problem of systemic risk. As long as massive financial institutions continue to take on huge amounts of risk, there remains a strong possibility that governments will once again face unexpected liabilities and collapsing tax revenues in a financial crisis – pushing up debt by another 40 percent or so of GDP. Yet discussion of this risk was largely absent from the recent Senate debate on financial regulation.

Financial crisis and recession are only half the story. The other half is long-term entitlements. Under the Congressional Budget Office's "alternative fiscal scenario," which includes policy changes that are politically likely, government debt in private hands will grow to 185 percent of GDP by 2035 as Social Security, Medicare, Medicaid and other health care programs grow to consume almost all tax revenues.

This should not be a surprise. In 2000, the budget office had already projected that these programs would grow to more than 16 percent of GDP by 2040 – a figure virtually identical to current estimates. This was predictable because it rested on two simple trends: changing demographics and, more importantly, high health-care cost inflation.

For many commentators, the only possible response is immediate austerity – the course being taken in Britain and parts of the euro zone. Already the national debt is being used as a hammer to beat down any proposed government spending, no matter what its merits. If we continue to spend, the argument goes, markets will lose faith in our ability to repay our debts, interest rates will skyrocket, the dollar will collapse and our way of life will be at an end.

While this argument is plausible in the abstract, there is no reason for panic. For starters, the Treasury Department can currently borrow money at historically low interest rates. This is no surprise. Investors around the world like saving in a safe currency, the dollar has traditionally been seen as the safest of currencies and recent developments in Europe and the rest of the world have done nothing to change that.

It is true that markets can suddenly lose confidence in a country, with severe economic repercussions. But there is no magical threshold that suddenly makes a country a poor credit risk; Japan's net government debt relative to its economy is roughly at Greek levels, yet Japan can still borrow money cheaply. A country's ability to borrow is determined by its economic fundamentals, its position in the international economy and the credibility of its political system relative to other systems.

So while an extra dollar of spending today is an extra dollar (plus interest) of debt later, what really matters are policies that affect taxes or spending year after year. In contrast, $34 billion for extended unemployment benefits – a temporary program that will become smaller as unemployment falls – has no appreciable impact on our structural deficit.

What do matter are taxes and entitlements. Therefore, the coming battle over the Bush tax cuts is of real importance. According to the Congressional Budget Office, extending the Bush tax cuts would add $2.3 trillion to the total 2018 debt. The single biggest step our government could take this year to address the structural deficit would be to let the tax cuts expire. And a credible commitment to long-term fiscal sustainability should reduce interest rates today, helping to stimulate the economy.

Critics say that this amounts to increasing taxes at a time of high unemployment, and that instead the tax cuts should be extended as a stimulus measure. This overlooks the fact that tax cuts are an inefficient form of stimulus, because many people choose to save their additional income instead of spending it.

If the goal is to boost growth and employment immediately, it would be better to let the tax cuts expire and dedicate some of the increased revenue to real stimulus programs. Alternatively, if some tax cuts are extended – as it seems likely that at least those for the middle class will be – there should be provisions to eliminate them automatically when unemployment falls to a preset level.

This post appeared today on the [NYT.com's Economix blog](); it is used here with permission. If you would like to reproduce the entire piece, please contact the New York Times.

Monopoly and Taxes

By James Kwak

A couple of weeks ago, Planet Money did a podcast based on a game of Monopoly. One of the participants was Russell Roberts, who professes to hate monopoly because it teaches the wrong lessons about business and the economy. At one point, Roberts said he would prefer the game if it had a progressive income tax with transfer payments to poor players. "As a result of that, you could get kids to resent taxes at an even earlier age."

But Daniel Hamermesh, who likes Monopoly, called him on it. Hamermesh pointed out that if you had a transparent system of taxing the rich and transferring the money to the poor, players in the aggregate would be neutral, and might even understand the whole point of taxes and government spending.

Our national hatred of taxes is based on Roberts's opinion times 300 million. The anti-tax electorate doesn't realize that many if not most of its members are net beneficiaries of the tax system. If you have a progressive tax system (where the rich not only pay more in taxes, but pay proportionally more), then the tax burden is falling disproportionately on a minority of the population, and hence the rest of the population should be better off. (There's an assumption here I'll come back to.)

But people don't realize this because, like Roberts's hypothetical child encountering the tax system for the first time in Monopoly, they only see the tax side of the equation. Leaving aside poverty programs (since those do only affect a minority), they forget about Medicare ("keep the government away from my Medicare"), subsidized student loans, national security, police and fire services, public schools, roads, consumer product testing, clean water, parks, unemployment insurance (the middle class lose their jobs, too), the invasion of Iraq (which was wildly popular back in the day), bailouts of the financial system, and all the other things they get from the government. (If you count tax expenditures as spending, the list gets longer, and includes the mortgage interest tax deduction, the 401(k) deduction, and the employer health insurance exclusion–all of which disproportionately favor the wealthy.)

Now, the assumption is that the government is not wasting people's money, and the intelligent counterargument is that because of government waste (due to political meddling and the lack of the profit motive, among other things), a significant proportion of tax revenues simply go up in smoke. The counterargument is that instead of giving the money to politicians to spend, people should keep it and give it to private companies that provide goods they want. So, for example, if a road needs to be built, some company will build it, and will then charge people who want to use that road.

For some types of services, this might be more economically efficient, in the sense that less money will be wasted on roads that people don't actually want. (For other types of services, like invading Iraq, it wouldn't work at all.) But it also means that people will only get what they pay for; that is, the poor and middle-class majority of people will no longer be able to benefit from the taxes paid by the rich minority. So for the median taxpayer, there's some quantifiable proportion of tax revenues the government would have to waste before taxes as a whole become a bad deal. Yet many people's starting assumption is that taxes are bad for them.

There are many mysteries about Monopoly, and actually people have been modifying the rules for decades. The thing that I wonder about is the $200 for passing Go. Isn't that the welfare state in its purest form–money you get just because time passes?

Update: Russ Roberts responds.

More Telecom Hell

By James Kwak

So, I wanted to transfer phone and DSL from one house to another. I went to Verizon's web site, clicked on the promisingly named "Moving to a New Home" link, and walked through the step-by-step wizard. It said I could have unlimited domestic calling and 3 MB DSL for $55 per month, which was a better deal than I was currently getting, so I signed up. The only issue was that the scheduling calendar only allowed install dates in the next month and I wanted a date six weeks out, but the live chat representative said I could just call in later and change the install date.

A few days later I went online to check on the order status in their online system and saw that my DSL order was nowhere to be found. So I called up and, after much misunderstanding and aggravation, I figured out that my order had been canceled by their back-end system. Even though the front-end (web) system knew that I was an existing customer (remember, I clicked on "Moving to a New Home") and offered me a discounted bundle, the back-end (probably mainframe system) didn't want to give discounts to existing customers and wouldn't allow the order to be processed.* After a little arguing, the representative said that she would manually book the order at the higher price and then go in and give me the originally promised discount.

The next time I checked my order status I saw that I had *three* different DSL orders in their system, which made me nervous, but there was nothing to do but wait.

Then, during the dead period (the period when I didn't want service anywhere), I got a bill. That bill showed that my phone service had been suspended correctly, but I was being billed continuously for DSL. I chatted online with a Verizon rep, who said that my DSL order had been set up as a move to happen all on the same day (July 26, the date I asked for the installation). She said that she could not change the order, but I could call customer service and they could maybe change it. I didn't want to mess anything up, so I asked her to verify that DSL service would move to the new address on July 26, and she said yes, so I just left it at that.

Eventually the install date came, the phone worked, and the DSL didn't. I also got a bill that only mentioned phone service, not DSL. And my online account only showed phone, not DSL. No big surprise. I started a chat session with a Verizon rep, and he insisted repeatedly that my DSL was working, and he had some system that showed it was working. When I pointed out all the evidence that it was not working, he told me to go check the modem and look at the light.

So I went back to the house with the non-working DSL, verified that the DSL light was blinking (bad), and called tech support. After the many prompts, during which the nice recorded voice told me I should turn off the DSL modem and turn it back on, the person I reached quickly verified that my DSL was *not* working, which makes me wonder what system the previous person was looking at.**

After some more investigation, he said that in his "system," it showed both that my DSL order had been canceled and that there was a delay with the installation. (This is probably because, remember, I had three different orders in the system. The original order is probably the one that got canceled, and the newer one had some unexplained delay.)

At this point I said that if they couldn't fix the problem, I was going to cancel what was left of the DSL order and switch everything to Comcast. This was partly due to frustration with the installation process, but partly due to the fact that at this point I was sure I wasn't going to be able to convince them to give me the discounted bundle (the agent I had spoken to earlier either lied to me or was unable to do what she said she would), and without the discount Comcast is cheaper. So then the agent said he would transfer me to some other vaguely named group of people who could solve my problem. He tried that for about ten minutes before telling me that, since it was after 5 pm (on a weekday!), that group had gone home, so I should call the next day. I asked instead if he could simply ensure that all my orders were canceled so that I could go switch to Comcast, and he said only the billing department could do that, and he would transfer me. So he transferred me, I waited on hold for ten more minutes, and then I just hung up the phone.

I did go through with the threat to switch to Comcast, but that was no walk in the park, either. First I called, told the IVR system that I was a current customer, told it that I wanted new products, and ended up with someone who not only couldn't help me but couldn't even transfer me to sales. When I said I had tried to get to sales, she tried to transfer me, but a minute later the phone went dead. I called back in again, told the IVR system I was not a current customer, and ended up with someone who asked me where I lived and then transferred me to a voice message that said their office was closed. (This is before 7 pm on a weekday.) Finally I entered my order online, and now I'm hoping it will work.

So why did I make you wade through my personal customer service nightmare? (Actually, I didn't make you–you're free to leave anytime you want.) Well, partly because it's therapeutic to be able to complain about bad customer service in public. But there are also a couple of lessons here about how the business world operates.

The first is that the business world runs on software, and most of it is bad software. The back end of just about any major company is a tangled mess of archaic, poorly coded, worse maintained, incompatible software programs written over the past forty years. When you're dealing with millions of customers via thousands of customer service representatives, your company is only as good as your software. If Verizon had good software, none of these problems would have happened. The web site wouldn't have let me place an order that would cause the back end to choke; the scheduling system would have gone out more than a month; the order status system would have had usable information; the billing system would have realized that I wasn't using DSL; the tech support system would have realized DSL was down; a single customer service system would have shown each rep all of my previous interactions; the poor rep at the end would have known which teams were still available; and anyone would have been able to escalate my problem to someone who could fix it.

The second is that oligopolies are bad for customers. Switching from Verizon to Comcast wasn't nearly as joyous as dumping Bank of America for a local community bank was, because I'm just trading one member of the duopoly for the other. In theory, duopolies are supposed to be somewhat better than monopolies. (Draw the demand and supply curves and you could figure it out, although it's been over a decade since I did.) But in practice they're usually not, because it doesn't take a lot of signaling for two companies to agree to charge the monopoly price. The same goes for customer service; they can both suck, but as long as neither is significantly worse than the other, there's no reason for either to change, since their churn rates are more or less the same.

Since the 1980s, we've had cable TV, cell phones, the Internet, satellite . . . and no significant increase in telecom competition. What's wrong with this picture?

* The software problem here is that the back-end system has some rules–"edits" in mainframe terminology–that have to be manually replicated in the front-end system. Otherwise data can get through the front-end system that the back-end system doesn't know how to handle. Whenever companies write web front ends for mainframe back ends, they make this kind of mistake.

** I'm not surprised that, say, Verizon's Internet and phone people look at different systems; that's not good, but it's common. I am surprised that their chat and phone tech support people look at different systems; that's crazy. Or maybe some of them just don't know how to use them.

AFL-CIO: Stronger Financial Reform Would Have Saved Jobs

The Baseline Scenario » 2010 » August 8/19/10 at 6:34 AM Simon Johnson

By Simon Johnson

The Brown-Kaufman SAFE Banking Amendment proposed a hard size cap on our largest banks, limiting their assets to a very small fraction of the size of our economy. The premise was simple – and could fit on a bumper sticker (or in a campaign flyer for November) – "too big to fail" is too big to exist.

But this proposal to modify the Dodd-Frank financial reform bill failed in the Senate in early May, by a vote of 33-61, with 27 Democrats voting against the idea. Since that time, Democratic supporters have been asking their representatives the obvious question: Why did you vote against Brown-Kaufman?

Interestingly, no senators yet have replied – at least on the record – that the power of the megabanks was too great to be overcome. Instead, there are three main arguments going the rounds.

First, some argue that the Brown-Kaufman would by itself not have completely solved all the problems that can cause our financial system to meltdown. As one senator put it in a recent letter, "[Brown-Kaufman] would not solve the problem of systemic risk and systemically important institutions in a comprehensive manner."

Another senator claims in a recent email to a constituent, "The notion of "too big to fail" is not simply about size, but is more about risk, leverage and interconnectedness; in many instances, breaking up financial institutions is not the most effective way to curb risk."

These are odd arguments, because no one ever claimed that limiting the size of our largest banks was sufficient for financial stability. Rather the argument was that this step was necessary – given the political power of these banks and their manifest ability to individually (and collectively) wreck great damage.

In addition, while the slogan "it's all about interconnectedness" sounds fine at the level of sound bites, the harsh reality is that the very best technology available for measuring interconnectedness between financial institutions is still a long way from being ready to guide policy. If you are waiting for the government to get a firm grip on this concept and, for example, for the Federal Reserve to do something about it, you will wait a very long time.

Second, it is also claimed – for example by leading members of the administration (in private) – that Brown-Kaufman would somehow have led to job losses and lower tax revenue. This is also an odd claim, because the amendment had a three year phase in period, which would have provided ample time for the financial system to adjust.

Rich Trumka, President of the AFL-CIO, has waded in on that specific issue, in a detailed written exchange with one member of Congress that refutes the claims of likely job losses. As Trumka puts it,

"Moreover, it was the financial crisis and the reckless speculation of too big to fail financial institutions that caused 8 million working people to lose their jobs and huge drops in the stock market and losses to pension funds."

The big potential distortion in our lending markets moving forward, as Trumka points out, is that "too big to fail" banks can borrow more cheaply than their competitors – because their creditors feel there is an additional level of implicit government guarantee available to the biggest banks, precisely because their failure would cause an unacceptable level of collateral damage.

Nothing in the market reaction since Dodd-Frank passed suggests that this perception – and this reality – has at all changed. Such a distorted system most likely leads to further financial excess – followed by crash and painful rounds of job loss.

Third, it is claimed that Brown-Kaufman would "affect the global competitiveness of US banks and could potentially undercut our banks' ability to finance the largest companies worldwide."

This is completely implausible. Brown-Kaufman would have reduced the size of precisely five large banks – and it would have reduced them to a size they last had a decade or so ago, when both the financial system and the nonfinancial part of the economy were much healthier. There is precisely zero evidence that the nonfinancial part of our economy would have been harmed.

Trumka sums it all up well, "By voting against the amendment, you voted to continue the status quo, to avoid addressing the problem of too big to fail institutions and to leave our economy at risk of another financial crisis precipitated by the failure of a systemically risky institution."

An edited version of this post appeared this morning on the NYT.com's Economix; it is used here with permission. If you wish to republish the entire entry, please contact the New York Times.

Management Consulting Myths

The Baseline Scenario » 2010 » August 8/21/10 at 10:49 PM James Kwak

By James Kwak

Two people forwarded me Johann Hari's Huffington Post article about management consultants, provocatively titled "The Great Management Consultancy Scam — and How it Could Be Coming for Your Job." It seems that someone is once again bashing management consultants as witch doctors and scam artists, and I, improbably, must come to their defense. "Improbably" because I am generally critical of management consulting, and I have spent many hours with former McKinsey colleagues talking about how little we knew back when we were consultants. I am frequently asked by other students whether they should become consultants, and my general answer is, in a nutshell, "It's a lousy job, and not nearly as exciting as the recruiting pitch makes it out to be, but it's a good thing for your resume if you actually want to be in the business world." (If you know me and are actually considering becoming a consultant, feel free to call me.)

Hari's article is largely based on books by former consultants, primarily David Craig's "brave" memoir (written five years ago; David Craig is a pseudonym). Here's a quote from Craig: "We were proud of the way we used to make things up as we went along. . . . It's like robbing a bank but legal. We could take somebody straight off the street, teach them a few simple tricks in a couple of hours and easily charge them out to our clients for more than £7000 per week." According to Craig (according to Hari), all of management consulting boils down to recommending that the client lay off thirty percent of its staff, after one week of observation and analysis.

Hari also cites Matthew Stewart, for whom (according to Hari) consulting was also all about firing people: "he was taking a fortune in payments, and firing thousands of productive people." That is not really what Stewart is about, at least according to his own article, although I don't agree with him either.

Here's where I need to give my disclaimers. I was only a consultant for a little less than three years, from 1997 to 2000. I only worked at one firm, and only in two offices of that firm. So my experience may not be representative. But since McKinsey is widely considered the premier management consultancy, any criticism that doesn't apply to McKinsey somewhat misses the mark.

I worked on nine client projects during my time in consulting, and only one and a half had anything to do with cost-cutting.* In both of those cases, a large proportion of the cost savings came not from firing people, but from dealing with various systems problems. (And in neither case did the recommendations come after one week.) The other projects were a combination of strategy, mergers and acquisitions, entering new markets, and implementing new processes.

Besides the supposed focus on cost-cutting, another part of the stock criticism repeated by Hari is that consultants take untrained people right out of school and bill them out for large amounts of money. This is true, but it misses the point. Yes, it may seem shocking that new consultants cost 7000 pounds per week. (That's Craig's figure—if I told you the McKinsey numbers, the Firm** might send someone to kill me and make it look like an accident.***) But they get it because those people, as part of McKinsey teams (I'm not going to speak for the competition), do work that most large corporations are simply incapable of doing internally.

The fact is that first-year McKinsey associates are very smart, very ambitious, very hard-working, and very insecure people. That insecurity is crucial, because it means they will metaphorically kill themselves before they will fail to do whatever they are asked to do, even if it is typing hundreds of numbers from printed reports into a spreadsheet and averaging them, or flipping through dozens of bound reports to make sure that none of the pages was photocopied incorrectly. Plugged into a consulting team, they provide leverage—the ability to get large amounts of moderately high quality work out of a team where only a few people—the more senior members—know what they are talking about.

Now, there should be a cheaper way to get the same results than hiring McKinsey to get them for you. But most companies, for whatever reason, are incapable of doing it internally. Any company only has a finite number of smart, ambitious, hard-working, insecure people. And—here's the problem—they are already doing the most important jobs in the company. They are running business lines, or designing products, or selling products, or keeping important customers happy—

all the things a company has to do to be successful. They can't be spared to go work on some consulting project. I've seen internal consulting arms of Fortune 500 companies and, believe me, you are better off paying the premium and hiring McKinsey. My old software company had a higher proportion of overachievers than any other company I have ever seen, and there is no way we could have spared four good people to work full-time on some research project for four months.

So what's the secret to the McKinsey model? There are a few, and they are interconnected. One is that, however they did it, they created an institution that is prestigious enough to skim off some of the top people produced by our educational system—which is, at its high end, probably the best in the world. Then, having secured those people, they figured out how to resell them to ordinary Fortune 500 companies—who can't hire them out of college, because what twenty-two-year-old wants to work for Proctor & Gamble?—at a huge premium. Sure, the clients aren't always happy. But they don't really have a choice. Because every now and then, a big company has an important question, like whether or not to enter a new market, and it cannot find the people internally to answer the question (again, because the best ones are too important to take away from their day-to-day jobs). And the question is so important that it dwarfs the premium that McKinsey charges relative to other consulting firms.

Is this good? Hari talks about how "the better you treat a workforce, the better they work," and I agree with that. But McKinsey is not going around telling companies to abuse their workers (at least not the large majority of the time), unless it's changed drastically in the past decade. Maybe the other management consulting firms really are as bad as Craig and Stewart make them out to be; I have no idea. Big companies do need people to study important questions now and then, and for many of them management consultancies are the only way to find those people. They should always read the reports carefully, understand all the assumptions, and challenge the conclusions. But if they do that, management consultants are not a bad way to get the grunt work done.

There is a more intelligent criticism to be written about management consulting. And there is a better way for companies to use management consulting services. But those will have to wait for another blog post, or for my own memoir (which is somewhere in the backlog of books I'm planning to write but probably won't get to). If Craig's and Stewart's books are anything like Hari makes them out to be, though, they've missed the point.

* One project had two parallel components, one of which involved cost-cutting.

** Yes, (some) people at McKinsey do refer to their company as "the Firm," with a capital "F."

*** That was a joke. But McKinsey is very serious about confidentiality, and I see no reason to betray its confidences.

Housing in Ten Words

The Baseline Scenario » 2010 » August 8/23/10 at 10:04 AM James Kwak

By James Kwak

"Housing Fades as a Means to Build Wealth, Analysts Say." That's the title of a *New York Times* article by David Streitfeld. Here's most of the lead:

> "Many real estate experts now believe that home ownership will never again yield rewards like those enjoyed in the second half of the 20th century, when houses not only provided shelter but also a plump nest egg.
>
> "The wealth generated by housing in those decades, particularly on the coasts, did more than assure the owners a comfortable retirement. It powered the economy, paying for the education of children and grandchildren, keeping the cruise ships and golf courses full and the restaurants humming.
>
> "More than likely, that era is gone for good."

I've been telling my friends for a decade that housing is a bad investment. These are real housing prices over the past century, based on data collected by Robert Shiller:

Housing is generally a worse investment than either stocks or simple U.S. Treasury bonds. Then why do so many people think it's such a great investment?

1. Leverage. Housing is the one area where ordinary people can get 5x, 20x, 30x, or even (during

the boom) infinite leverage on their capital at a decent interest rate. With that kind of leverage, even a modest real return on the underlying asset turns into huge returns on your capital. Of course, we all know the dangers of leverage.

2. Price illusion. People remember the nominal price they paid for their houses. When they sell them thirty years later, they look at the difference between the nominal purchase and sale prices and think they made a ton of money. This is especially true of the generation that bought houses in the 1960s and early 1970s before inflation hit; they saw their home prices go up by a factor of ten and thought it was due to high real returns.
3. Bubbles and optimism bias. Every now and then we have a huge bubble like the one at the right-hand end of the chart above. For a while, people think that's the new normal. For a while after that, they continue to think it's the new normal, because they are biased toward optimistic expectations about the world. (Note that during the first half of the decade that I was advising friends that housing was a bad investment, housing was actually a great investment, assuming you could get out in time.)

OK, so now we all now the real story. Or do we? "In an annual survey conducted by the economists Robert J. Shiller and Karl E. Case, hundreds of new owners in four communities — Alameda County near San Francisco, Boston, Orange County south of Los Angeles, and Milwaukee — once again said they believed prices would rise about 10 percent a year for the next decade." There's that optimism bias.

But I don't think it's correct to say that an era is over–an era when housing appreciation was the key to the economy. The chart above shows simply that that era never existed; housing was flat for a long time, and then there was a bubble. Instead, we had the illusion of an era of housing appreciation, produced mainly by leverage and price illusion. For every homeowner who made a killing because she got a fixed-rate mortgage in 1970, there was a new family that couldn't afford a house in 1980 because interest rates were too high, or a savings and loan that failed because it was weighed down by those fixed-rate mortgages. That whole phenomenon was just a transfer of wealth within society.

One last caveat, however. When "analysts say" one thing, they are usually wrong. Remember back in 1999-2000, when most analysts were saying that stocks were the best investment for everyone, all the time? Generally the best time to buy an asset class is when conventional wisdom has shifted against it. So while I still think housing is overpriced–and we should slowly remove the props on that price, like the mortgage interest tax deduction–maybe in the long term it's not such a bad idea after all.

Update: An earlier version of this post had some incorrect calculations of the return on a hypothetical housing investment. Sorry–I'm out of practice at this blogging thing.

Fiscal Austerity and "Third World America"

 8/26/10 at 6:47 AM Simon Johnson

By Simon Johnson. My testimony to the Senate Budget Committee on these issues is available here: http://baselinescenario.com/2010/08/05/its-hard-to-take-the-fiscal-hawks-seriously/.

There are three main views of the financial crisis and recession of 2008-9. In the first two views, the debate over the fiscal deficit is quite separate from what happened in the crisis. But in the third view, the financial crisis and likelihood of fiscal austerity are closely linked.

The first is that something went wrong with the financial plumbing central to the world's economy. Failed plumbing is a serious business, of course – great real estate can be ruined by a burst pipe. But it's a technical issue; nothing deeper is at stake.

The Dodd-Frank financial reform legislation ended up addressing a myriad of technical issues. Clearly, "fix the plumbing" is Treasury Secretary Timothy Geithner's interpretation of what we need to do – he insists that making the system safer just requires "capital, capital, capital."

The second view is that the financial system is more deeply broken. Opinions vary in terms of the relative importance of various elements, including too-big-to-fail incentive problems that encourage banks to take on excessive risks – and to be supported by the credit markets when they do.

The first and second views are mutually exclusive – either our financial system is badly broken, or it is not and technical fixes will suffice. Both focus primarily on the nature of the financial system, somewhat in isolation from the rest of the economy. But a third view is increasingly emerging that implies both the first two views are too narrow.

This deeper critique is posed probably in its sharpest form by Arianna Huffington in her new book, "Third World America" (in the spirit of disclosure, please note that I am a contributing business editor at the Huffington Post). Her point is that we should not think of the last financial crisis in isolation, but rather as the outcome of a longer-run pattern of behavior. Excessive consumer debt is an outcome of prolonged inequality – in trying to remain middle class, too many people borrowed too much, while unscrupulous lenders were only too willing to take advantage of such people.

Raghu Rajan, the former chief economist at the International Monetary Fund, and Robert Reich, the former Labor Secretary, also have new books with related themes that link persistent inequality of income to the onset of financial crisis through various mechanisms – Mr. Rajan's "Fault Lines" is more about the global economy (and overspending at the level of the US economy); Mr. Reich's "Aftershock" focuses on the social and political impact of the crisis (and why, without addressing inequality, our financial problems will recur).

The distribution of income in the United States is undoubtedly becoming more unequal. Specifically, over recent decades, it has become harder for people with only a high-school education to build a secure middle-class future for their families.

We can argue about proximate causes, including the relative roles of new technology and globalization, but there is no question that unionized jobs, well-paying assembly line work and prosperous small-business niches have all tended to disappear.

The financial crisis may be behind us, but the link to the likely intense debate this fall regarding fiscal policy is direct — we are told that fiscal austerity requires outright and immediate further cuts in the benefits previously promised to people at the federal, state and local level.

Never mind that this is simply not true – at least in the form currently presented (here are a primer on short-term issues and another on the longer-term perspective). A vocal class of people – including some at the upper end of the income distribution – incessantly insist that "entitlements must be cut" while refusing to address the real causes of both our recent surge in government debt (the financial crisis, caused by perverse incentives in the financial system) and the genuine longer-term issues we face (which are about controlling the future increase in health-care costs – not cutting the level of benefits today).

The self-described "fiscal conservatives" really cannot be taken seriously – in the financial reform debate, they either didn't show up or preferred to keep the existing system in place, and they refuse to put serious health cost-control measures on the table.

If the "conservatives" don't really want to reduce the shocks that have caused government debt to explode recently – or to deal with the underlying, longstanding health-care cost issues in a reasonable fashion – what exactly is going on?

That's a question they should answer for themselves, and hopefully they will be pressed on this in public debates during the run-up to November's elections. But there is a striking similarity between the longstanding stated intention to "starve the beast" (meaning press for reduction in government by creating binding constraints, like a perceived crisis) and what we are seeing play out today.

And there is very real danger that this strategy will work, in the sense that the contours of a coming "fiscal crisis" – what will be discussed and how the issues are framed – will largely be structured by scaremongers who wish to cut pensions and health-care benefits for middle Americans in the years ahead and who will work hard to keep meaningful tax reform off the table.

People who push for this view are not being fiscally responsible, and they are well down the road to exacerbating third world-type problems in the United States – and to creating the conditions for another financial crisis.

As drafted for the NYT's Economix blog; used here with permission. If you would like to reproduce the entire post, please contact the New York Times.

Democracy in America

The Baseline Scenario » 2010 » August 8/26/10 at 10:34 PM James Kwak

It appears that Simon beat me to commenting on *Third World America*, Arianna Huffington's bleak portrait of many of the things that are wrong with America (crumbling infrastructure, failing schools, extreme inequality, low social mobility, political system captured by special interests, etc.), so I'll confine myself to a couple of thoughts I had while reading it.*

First, there are these great quotations from Alexis de Tocqueville's *Democracy in America* (p. 45 of Huffington's book):

> "Amongst the novel objects that attracted my attention during my stay in the United States, nothing struck me more forcibly than the general equality of condition among the people. . . .
>
> "Democratic laws generally tend to promote the welfare of the greatest possible number; for they emanate from the majority of the citizens, who are subject to error, but who cannot have an interest opposed to their own advantage."

Now, Tocqueville was no naïve idealist. I read a big chunk of *Democracy in America* in college (the "cube," we called it, because it was so thick) and read *The Old Regime and the Revolution* in graduate school, and Tocqueville is one of the two conservatives I most respect, along with Edmund Burke. He knew the importance of institutions and the dangers of trying to overthrow them all at once, and hence his distaste for the ideological zealots of the French Revolution. America, he thought, was different, because of its strong institutions and public sphere.

But today, Tocqueville's observations no longer ring true. America is no longer a land of equality, and it's largely because our democratic system no longer promotes "the welfare of the greatest possible number." And that's because many citizens are only too eager to support policies that are "opposed to their own advantage," like the then-popular (and apparently still-popular) Bush tax cuts, which shifted the relative tax burden from the rich onto the middle class.** What Tocqueville underestimated was the power of money in modern politics and the marketing genius of modern politicians, which have freed democratic politics from the constraints of the actual interests of the majority.

Second . . . I think I'll hold off on second until another post.

* I got a free copy from the publisher.

** Yes, income taxes on the middle class went down a bit. But if we assume that government spending must eventually be paid for, it's the relative distribution of the tax burden that matters. If we assume instead that government spending will be reduced, those reductions will affect the middle class (Social Security, Medicare, etc.) much more than the rich.

Central Clearing and Systemic Risk

The Baseline Scenario » 2010 » August 8/30/10 at 7:30 AM James Kwak

This guest post is by Ilya Podolyako, member of the Yale Law School Class of 2009 and a friend of mine. Ilya led the Progressive Economic Policy reading group with me and served as an adjunct professor of law at DePaul University this past spring.

One of the key provisions of the Dodd-Frank Act is Title VII, which requires all non-exempt derivatives transactions to go through a central clearinghouse (this report provides a good summary). As James and Simon have explained, the Dodd-Frank Act uses the term "swap" as a big basket that captures most financial products that we would normally call derivatives: options, repos, credit default swaps, currency swaps, interest rate swaps, etc.

Prior to the passage of the Act, most of these products were sold over-the-counter by certain large institutions. That is, in form, a transaction where you wanted to buy a credit default swap triggered by some event (say, the bankruptcy of Ford Automotive) resembled a trip to the car dealership. The dealer had inventory on the lot; this inventory was split into several different models / types of product; individual instances of a given model were relatively homogenous and varied mostly by color and minor adornments (spoilers, leather seats, etc.). If you were looking for a car of a given make and model that had certain extra features, a dealer might be able to get one custom-built for you at the factory, but you'd have to wait for the item and pay extra. Of course, the salesperson would not be able to accommodate all requests – if you show up to your average Chevy dealership and ask to buy a jet-powered car, you are likely to leave empty-handed no matter how much money you have, even though a few other individuals have been able to procure said exotic item.

From a structural perspective, an important characteristic of the new car market and other OTC markets is the absence of publicly available information about other transactions. Thus, when you show up to the dealership, you see only the sticker price, which is unlikely to be what prior customers actually paid to take drive the car off the lot. A related and notable feature of OTC markets is the ad hoc nature of customer-retailer pairings within them. That is, such markets usually have multiple parties independently striking their own deals for the same product; the coupling depends on chance, networks, and amenability to agreement. Predictably, in this environment, the final terms could differ quite drastically from one transaction to the other – prices could vary, some parties could be excused from performance in circumstances where others aren't, warranties may apply to some sales but not others, etc.

By contrast, a centralized exchange pairs buyers with sellers on terms visible to everyone and pursuant to some fixed queuing algorithm. To switch metaphors for a bit, exchanges are like a reality TV show about a match-making service – a bossy central character sets everyone up while the cameras are rolling and even nonparticipants can witness the results. In this frame of reference, an OTC market is like a college bar – transactions are happening between some parties based on pre-existing relationships, between others who don't know each other based on clearly indicated mutual interest, and between others still based on mutual acquaintance with an intermediary. The point is that an observer sitting in the corner of the bar might be able to figure out who has successfully negotiated a deal and who hasn't based on secondary indicators like changes in the number of buyers and sellers remaining on the floor, but won't have any clue as to the specifics of a given transaction or even the average negotiation.

Dodd-Frank does not mandate that private OTC swap markets convert to exchanges (such a requirement may exceed Congress's Commerce Clause powers and would be unprecedented in the securities arena). Instead, it uses a more subtle measure to centralize and standardize derivatives trading by requiring most such transactions to go through a clearinghouse. A clearinghouse is sort of like an exchange in that both facilitate trusting interaction between buyers and sellers, but the two types of entities go about their mission in different ways. An exchange makes traders more confident they are getting the best possible price by making the market more transparent. A clearinghouse, on the other hand, makes traders more certain that the seemingly excellent price that their counterparty just agreed to pay is actually the amount of money they will receive when the transaction ends. In an OTC market, that can be far from certain, especially for a longer-term product, like a credit default swap covering a five-year period. In that time, even a CDS seller that was solvent at the time the deal was originally struck could become financially unsound (perhaps, because like AIG, it spent years handing out CDS's for pennies to anyone who would ask) and be unable to meet its contractual obligations. If the buyer of the CDS found such an irresponsible seller on his own in the OTC jungle, the buyer would have no recourse to anyone else. He could sue the seller or try to extract the money in some other way, but if this money had already leaked out by the time the triggering default event occurred, the buyer would be left holding nothing by a worthless contract in his hands.

A clearinghouse ameliorates such risk by standing behind every transaction and ensuring that it goes through. More specifically, pursuant to previously accumulated legal authority, the clearinghouse takes contracts setting out each deal, "splits" them into two – one setting out a sale and the other setting out the countervailing purchase – and substitutes its name for the counterparty in each half of the transaction. This process, known as novation, ensures that the clearinghouse becomes the seller for every buyer and the buyer for every seller. In doing so, it absorbs all of the counterparty risk from the market, but keeps a posture that is indifferent to changes in the price of the underlying asset because all of its long positions (obligations to buy an asset) match up with short positions (obligations to sell an asset).

The business of a clearinghouse thus closely resembles that of a specialized (monoline) insurer. The clearinghouse makes money in a similar way too – by charging a fee for every transaction it processes. Clearinghouses are usually mutually owned by the members / clients whose transactions it will stand behind. These may include banks, hedge funds, large broker-dealers, and exchanges (who own two of the largest existing American derivatives clearinghouses, CME Clearing and the OCC). These members are responsible for contributing money to an emergency rescue fund in rough proportion to their trading activity, maintaining capital accounts that satisfy a performance margin , and, in some situations, usage fees (though capital contributed free of charge and not subject to an interest rate obviously counts as an implicit fee). Clearinghouses may also call on their members to contribute additional capital or absorb the positions of a member that cannot meet its obligations at any time. Their business model is thus subject to significant network externalities, because a clearinghouse that includes only a few small companies will process exponentially fewer transactions than one that includes all of the major market participants. Moreover, the smaller clearinghouse may attract less financially stable participants and thus carry more counterparty risk on any transaction than a large one. These parameters explain why the existing private-sector clearinghouses enjoy a near-monopoly in their markets.

Clearinghouses aren't unique to the derivatives arena. They serve as key intermediaries for the stock market and electronic fund transfers. The Federal Reserve is a clearinghouse of sorts, in that it facilitates transfers of assets from one bank to another. Indeed, in the era prior to the existence of the Federal Reserve, banks formed their own regional clearinghouses as a means of assuring investors that an individual bank failure would not jeopardize their savings. These structures proved popular but not particularly effective.

Herein lies the problem. A clearinghouse is a private business that puts its own money on the line. It works by ensuring that its members are actually well-capitalized institutions capable of paying for bets they made, and thus closely scrutinizes the risk profile of each participant's portfolio on an ongoing basis. This access permits a clearinghouse to observe otherwise opaque OTC markets with great precision and provide valuable data on concentration, exposure, and capitalization to regulators. Meanwhile, under normal circumstances, the clearinghouse can neither borrow from the Federal Reserve nor receive government backing for its capital. So what could go wrong with using these organizations to grab control over derivatives?

Well, while in theory the model sounds good, history has demonstrated that private sector risk aggregators routinely underprice systemic, correlated risk. AIG provides the most startling example of this behavior. From 2005 to 2008, its Financial Products group essentially acted like a clearinghouse gone mad, willing to become the counterparty to nearly every bet by writing billions of dollars (in then-notional, subsequently real value) worth of credit default swaps without holding on to capital or hedging its reference product risk. A similar tendency to charge too little for catastrophic risk undermined the finances of MBIA (initially formed by a consortium of principal insurance companies in a structure reminiscent of the OCC) and AMBAC, the main monoline insurers, whose credit ratings were rapidly cut during the credit crisis. Fannie and Freddie are even better examples, because government housing policy exacerbated their natural tendency to underestimate the likelihood of fat-tail events and charge too little for their guarantees of conforming RMBSs.

Now that clearinghouses have become ingrained into our official market framework, they are likely to become susceptible to the same business pressures that led other too-big-to-fail institutions to dance while the music is playing and not worry about what happens after. In the absence of mandatory clawback requirements, the people who own CME Clearing, OCC, and any other entity that can successfully break into the oligopoly will be able to benefit enormously by charging nonrefundable fees to process every transaction that the DF Act shoves onto their platforms from the previously scattered OTC markets. Realistically, they will continue to carefully monitor their members to avoid costly liquidation of individual portfolios, which cost real dollars from proprietary emergency funds and may decrease trade volume (and revenue) by frightening relatively cautious investors. But the possibility that these sophisticated, logical actors will overlook the fact that Congress has just anointed them as systemically critical parts of the U.S. economy (on whom farmers, power plants, and steel mills will depend to provide a backbone to their trades)* seems slim. I need not belabor the dangers of such awareness on this site.

Of course, social absorption of losses may be a fair price to pay for transparency, stability, and liquidity, at least in some circumstances. For example, the FDIC does just that, and it is widely recognized as a drastic improvement over earlier approaches to the banking system. On the other hand, a lack of centrally cleared derivatives did not cause the economic crisis; lax or nonexistent capital requirements for portfolios of these derivatives did. Clearinghouses can and do impose a version of these, but for the reasons stated above, their requirements are not likely to adequate. The Dodd-Frank Act is still a step in the right direction because it allows the government to survey the derivatives market in real time and stage precise rescue operations when necessary, but in this arena, as in many others, the reforms carry a significant cost.

*Most of these institutions should be able to avail themselves of the End-User exception in Section 723(h)(7)(A) of the Act, but their counterparties are likely to be large financial conglomerates who rely on clearinghouses to manage, clear, and hedge their exposure to any given farm or steel mill.

Hedge Fund Blindness

The Baseline Scenario » 2010 » August 8/31/10 at 11:56 AM James Kwak

By James Kwak

Hedge fund managers may be good at investing money. (Or they may just be the beneficiaries of luck, like successful stock mutual fund managers.) But that doesn't mean they can think clearly.

Andrew Ross Sorkin comments on the letter by fund manager Daniel Loeb, a former Democratic fundraiser, criticizing the supposed anti-business policies of the Obama administration. The letter includes blather like this:

> "As every student of American history knows, this country's core founding principles included nonpunitive taxation, constitutionally guaranteed protections against persecution of the minority and an inexorable right of self-determination."

Who, in making a list of America's founding principles, would put "nonpunitive taxation" first? Oh, right. A hedge fund manager.

More seriously, there is this:

> "Many people see the collapse of the subprime markets, along with the failure and subsequent rescue of many banks, as failures of capitalism rather than a result of a vile stew of inept management, unaccountable boards of directors and overmatched regulators not just asleep, but comatose, at the proverbial switch."

This is just sloppy thinking. I've written more than most people about "inept management, unaccountable boards of directors, and overmatched regulators." I've criticized the Obama administration in many more words than Daniel Loeb. But putting the blame on certain categories of people does not somehow absolve "capitalism." Our capitalist system–which until recently we considered the best, most pure version in the world–allowed incompetent people to become executives (and to run hedge funds), allowed incompetent people to become directors and to avoid any responsibility for their actions, and allowed companies to swamp regulators with battalions of high-priced lawyers and lobbyists.

This is a basic category error. Capitalism is an economic system; managers, directors, and regulators are people. They are not mutually exclusive. If you want to say that capitalism necessarily means universally good managers, responsible directors, and effective regulators, then that's an argument you have to make (and good luck making it).

Just because you make a lot of money doesn't mean you know what you're talking about. Unfortunately, in this country if you make a lot of money, a lot of people listen to you.

(Here's the full letter. Along the way, Loeb says that the current decline in confidence and economic activity is due to the SEC's lawsuit against Goldman.)