

Why China Is Unwilling to Revalue the Yuan

The Baseline Scenario » 2010 » October 10/1/10 at 8:41 AM Simon Johnson

*The following guest post was contributed by [Ian Lamont](#), an MIT Sloan Fellow. He was previously the managing editor of the *Industry Standard*, and has also [researched China's state-run media](#) and communications policies.*

For years, China has been subject to [enormous external pressure](#) to increase the value of its currency, or let it float on the open market. While doing so might relieve pressure on foreign economies by boosting their exports and reducing trade deficits, it runs counter to Beijing's domestic priorities, which involve doing everything it can to preserve economic growth and domestic stability, and by extension, its hold on political power.

All countries exploit the dynamics between their political and economic systems. But China's situation is exceptional. For three decades, the government of the People's Republic of China has perpetuated a grand political dream, claiming a single-party political mandate from the Communist ideals espoused by Mao Zedong, while simultaneously drawing power from the capitalist canon. Beijing has been able to pull it off, largely through the promise of spreading wealth and opportunities to even the poorest of villages and maintaining benefits for cadres and workers in state-owned enterprises which cannot easily be absorbed into the capitalist system. A high rate of GDP growth is required year after year to maintain this state of affairs.

A sudden change in the value of the Yuan could have the effect of throwing a wrench into the works, potentially setting off a chain reaction of factory closures and layoffs across the interconnected networks that drive China's export-oriented economy. In the short term, China might be able manipulate legislation, the banking sector, and welfare levers to prop up key industries or regions. But in the long term, it is uncertain if these steps would be enough to preserve social stability or continued loyalty to the Communist Party.

What sorts of domestic consequences would result from a slight uptick in the value of the Yuan? The currency is now trading at about 6.7 renminbi to the U.S. dollar. At the very least, Chinese exports would become slightly more expensive to foreign buyers. The resulting drop in Chinese exports would put marginal factories out of business and put their workers on the streets. Other companies would [shift low-wage manufacturing to countries such as Vietnam and Sri Lanka](#). In the industrial parks around Shenzhen, the unemployed could be reabsorbed into the local manufacturing economy. In remote interior provinces, where economic institutions are less developed, there would be fewer opportunities, and a corresponding rise in poverty, anti-government feeling, and isolated "[mass incidents](#)."

But what would happen in the case of extreme economic disruption, prompted by a sharp change in the exchange rate, the currency openly floating on the world market, or some other unforeseen

effect of a revaluation? The social and political turmoil unleashed by a sharp, sudden slowdown of the Chinese economy could potentially lead to Tiananmen Square-scale protests, widespread domestic instability, and an exodus of migrants or refugees to neighboring countries and overseas.

China is not attempting to hide its fears. “Any significant appreciation of the renminbi will erode China’s export competitiveness overnight and impact the livelihood of tens of millions of workers,” [notes an editorial authored by the pro-government *China Daily* and republished in China’s state-run news agency](#) in May. The essay further describes two economic goals: To maintain a target GDP growth of 8 percent per year (a level it has [achieved nearly every year for the past two decades](#)) and contain China’s consumer price index ([which it tries to keep under 3%](#)).

Additional factors may influence China’s currency policy in the short term. One concern is foreign policy, such as relations with key trading partners. Another is nationalist sentiment, which the Communist government [has manipulated](#) to support its own hold on power. Economic injustices inflicted by foreign powers on China in the 19th and early 20th centuries — such as the treaty ports system — [still play a role in China’s nationalist propaganda](#). These humiliations require the current generation of Chinese leaders to tread carefully around policy changes that could be viewed as kowtowing to foreign demands.

So, for foreign governments, companies, and labor groups expecting China to allow its currency to appreciate, there may be no significant movement until China’s back is truly against the wall — or the leadership in Beijing can find a face-saving way to convincingly portray a revaluation as an advance demanded by its people, as opposed to a policy shift dictated by foreigners. In addition, China’s trading partners need to be aware that a change in the value of the Yuan will not by itself erase their trade deficits or reduce their dependence on cheap manufactured goods from abroad. Such a shift may even lead to problems that have long-lasting implications for China’s people and the global economy.

[The Government Does Have Something To Do with It](#)

[The Baseline Scenario](#) » 2010 » October 10/6/10 at 9:28 AM James Kwak

*This guest post on the relationship of business and government comes to us from Lawrence B. Glickman, chair of the History Department at the University of South Carolina; the author, most recently, of *Buying Power: A History of Consumer Activism in America*; and an occasional contributor to this blog.*

One of the most telling statements of our political era, made ten years ago this week by Dick Cheney during his Vice Presidential debate with Joe Lieberman on October 5, 2000, was actually a misstatement that went largely unnoticed. And therein lies an important lesson about the place of

government in our political culture.

In response to the Democratic nominee Lieberman's jibe that Cheney had profited handsomely from the job he had recently departed as CEO of the Haliburton Corporation, the Republican nominee replied, "I can tell you, Joe, the government had absolutely nothing to do with it." Amid the laughter and applause of the audience, Lieberman chuckled good-naturedly and joked about joining the private sector himself.

Following the debate, media analysts focused on what the *New York Times* called Cheneys avuncular self-confidence but, like his opponent, they largely passed over the fact that his statement was a whopping lie. Despite his denial and his antigovernment rhetoric, the company Cheney ran depended on billions of dollars of government contracts and loan guarantees. It would not be an exaggeration to say that government was Haliburton's primary source of support.

How was it that such a statement, easily disproven, was left largely unchallenged? Part of the blame may be due to the shallowness of our televised politics, the media's obsession with humor, and a superficial conception of civility.

At a deeper level, Cheney was the beneficiary of a long-term campaign against government that at the time of his comment was at least three decades in the making, and that has reached new heights in our current political moment. A narrative pushed by conservative think tanks and parroted endlessly by politicians and pundits has prevailed in which the state, especially the federal government, is depicted in almost entirely negative terms, as a drag on the economy and a threat to freedom. In this view, government is the problem, as Ronald Reagan famously put it: government spending is always wasteful; government programs are at best mediocre and at worst dangerous manifestations of the nanny state.

This negative view of government has also been underwritten by an inaccurate version of American history. It has become a cliche to praise what Ronald Reagan called, in his 1964 attack on Medicare, our traditional free enterprise system and to describe the battle against government intervention in the economy as a return to venerable traditions. The prevailing narrative treats laissez-faire as the American norm and understands state intervention in the economy as a recent development.

History tells a different story. Ever since the Constitution was described in 1787 as a revolution in favor of government, Americans have recognized that the state has a positive and essential role to play in promoting economic dynamism and political freedom. Early national citizens promoted internal improvements. Nineteenth-century Republicans supported public spending on railroads and the democratic experiment of Reconstruction. Progressives endorsed antitrust legislation. Free and robust markets have been the wellspring of economic growth in the United States. But, from the Erie Canal to the Internet, government policy—including land grants and consumer protection laws—has provided a framework for markets to operate, choices to proliferate, and citizens to consume.

Despite their endorsement of the state's role as a creator of markets, provider of infrastructure, and consumer of goods and services, Americans have simultaneously held a longstanding suspicion of the state. What they most detested about the state as it existed in Europe was the way in which it granted privilege to the powerful and enabled the wealthy to further enrich themselves. They also feared the standing armies and the co-mingling of the military and the civil government that characterized Old World regimes. They feared the kind of arrangement that Cheney and his company profited from—what today we call corporate welfare and the military-industrial complex—and they did so not because they uniformly condemned federal power but because they feared a state that would entrench insiders and elites.

Cheney's comment is even more relevant today than it was when he uttered it a decade ago. Politicians and pundits continue to deny government's proper—and historic—place in economic development and equally to deny or minimize the dangers of government power as manifested by secrecy, the revolving door between business and government, and unscrutinized contracts handed out to private businesses like Haliburton.

We desperately need a narrative about the role of the government in our political and economic life to compete with the one that currently dominates the conventional wisdom. Such a narrative would hold that taxes are a means of raising funds for necessary collective endeavors, that regulation can just as easily promote as stifle freedom (such as the freedom to avoid toxic drugs and unsafe food), and that government can, as the Founders recognized, promote the general welfare. It need not celebrate all forms of government power and should call attention to the dangers of an overreaching state that we have become especially aware of over the last decade. Perhaps if such a narrative had been in place in 2000, Americans would be facing our current crisis with a more balanced sense of the strengths and limitations of government, and a more accurate sense of how our predecessors understood them.

Thoughts On The Macroeconomic Impact of Goldman Sachs

The Baseline Scenario » 2010 » October 10/7/10 at 5:37 AM Simon Johnson

By Peter Boone and Simon Johnson

The influential [Goldman Sachs](#) economist [Jan Hatzius](#) has a new research note out (with [Sven Jari Stehn](#)), "Thoughts on the Macroeconomic Impact of Basel III," arguing that the move to raise capital standards for banks will put a serious crimp in growth in the United States – knocking 1.5 to 2 percent off [gross domestic product](#) in the next few years. Their findings are questionable, but in any case we should broaden the discussion to consider exactly how banks like Goldman Sachs affect our macroeconomic dynamics going forward – particularly if they are able to effectively lobby against higher capital. Growth based on risky banking has a tendency to prove illusory.

There are three issues. First, what is the short-term impact of raising capital requirements? Second, how should capital be increased? And third, and perhaps most important, do we really need global banks like Goldman Sachs to operate in their recent “high risk – highly variable returns” mode?

In their note, which is not in the public domain, Mr. Hatzius and Mr. Stehn are willing to acknowledge that raising capital standards can help make banks safer and that this is good for sustained growth over a sufficiently long period of time (think a decade or more), as the Bank for International Settlements [suggests](#). But they make the case that raising capital – at least in the form that this is likely to take place – can slow growth over the next several years.

As they see it, forcing banks to have more capital (as a buffer against losses) relative to assets will increase their cost of capital – leading to higher lending rates and tighter credit standards.

On the merits of this point, Mr. Hatzius and Mr. Stehn unfortunately do not deal with or cite the detailed counter-arguments [put forward](#) by [Anat Admati](#), [Peter DeMarzo](#), [Martin Hellwig](#), and [Paul Pfeiderer](#) – top finance professors (three at Stanford; Professor Hellwig is at the Max Planck Institute in Bonn), who strongly assert that raising capital requirements would have minimal if any negative effects.

They argue that government subsidies to debt financing of large banks, through tax incentives and implicit guarantees (which relatively penalize equity financing) are inefficient and distortive, and that higher equity levels would reduce this subsidy and lead to fewer distortions in lending decisions. In particular, Admati and colleagues emphasize that because raising capital requirements makes bank equity less risky and banks less prone to collapse, it lowers the rate of return they are required to seek for equity funding.

(The perspective here is that everyone is looking for a combination of risk and return – if you offer a safer asset, it is fine with investors if that pays less return; this, in turn, means that bank executives do not need to seek risk so aggressively.)

Mr. Hatzius and Mr. Stehn also overlook [the point made persuasively](#) by [Anil Kashyap](#), [David Scharfstein](#) and [Jeremy Stein](#) (from the [University of Chicago](#), Harvard, and Harvard, respectively) and their co-authors that even if forcing banks to hit a particular capital-asset ratio could be contractionary (because the banks will dump assets), that will not constrain or limit credit.

The Obama administration has had many missteps with regard to banking – and should have run more demanding [stress tests](#) in spring 2009 – but there is no question that when the time came to force banks to raise capital, they used the right approach: they told the banks the precise amount, in dollars, that they needed to obtain from private markets (or receive public capital on terms they would not like – including with salary caps.)

But even if Mr. Hatzius and Mr. Stehn prevail on the short-term issues (at least in the corridors of power) and regulators target capital-asset ratios rather than the more sensible Kashyap-Scharfstein-Stein proposal, so what?

The rationale for the capital increase is that in recent years the financial sector imposed massive losses on the rest of society by the mismanagement of credit. If the big banks have become a machine that provides supernormal returns

to employees and creditors while causing frequent losses to taxpayers (through the fiscal costs, measured in terms of the increase in net government debt as a result of the [recession](#)), savers (because interest rates are cut to zero by the [Federal Reserve](#)'s policy response), and their own shareholders in many instances, then reducing the voracity of this machine is for the general good.

Correlations in economic data that suggest higher credit helps "cause" higher growth are not worth much – if they fail to take into account future losses on "bad credit." If G.D.P. were adjusted with provisions for future losses, G.D.P. growth would be lower during periods where credit grows very fast.

G.D.P. in the United States in real terms is currently at about the same level now as it was in 2006. (Real G.D.P., annualized, was around \$12.9 trillion in the first quarter of 2006 and \$13.2 trillion in the second quarter of 2010, although this number is still subject to revision; see Table 3B (on Page 19) in the [July 2010 report](#) of the Bureau of Economic Analysis). If you expect G.D.P. growth to be weak for the rest of this year – as does Goldman Sachs – and also factor in population growth, which is about 1 percent a year, very soon we will all realize that G.D.P. per capita has actually declined over the past half decade.

If we had stopped the excessive credit growth in the second half of the 2000s, we would have limited the boom – and also removed a lot of the downside damage.

Highly risky, massive global banks that are – post-[Lehman](#) – unambiguously "too big to fail" are absolutely not in the social interest. If we give up some short-term illusory growth as a side effect of curtailing their activities, this is a small price to pay.

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

Will The Volcker Rule Really Be Enforced?

The Baseline Scenario » 2010 » October 10/7/10 at 9:32 PM Simon Johnson

By Simon Johnson

The Financial Stability Oversight Council has put out a request for comments on the Volcker Rule – if you write to them soon, they may actually listen.

One big issue is whether there will be high frequency monitoring of trades by big banks – potentially enabling regulators to know if the "no proprietary trading" rule is being violated. The default approach is probably to have a hands-off, light touch – pretty much continuing our recent and not-so-distinguished traditions with regard to supervising banks.

I go through the issues in more detail – including who seems to be on what side within the government – in a [Bloomberg column that appeared this evening](#).

Update: Sending Comments To The FSOC

The Baseline Scenario » 2010 » October 10/12/10 at 9:18 AM Simon Johnson

By Simon Johnson

Update: the link for sending comments to the FSOC on the Volcker Rule is in [my Bloomberg article last week](#). Some of you have asked for me to also post it on BaselineScenario – [click here](#) or cut and paste this address:

<http://www.federalregister.gov/articles/2010/10/06/2010-25320/public-input-for-the-study-regarding-the-implementation-of-the-prohibitions-on-proprietary-trading>

What Has Microsoft Come To?

The Baseline Scenario » 2010 » October 10/12/10 at 12:46 PM James Kwak

By James Kwak

From [The New York Times](#):

“Consumers will be able to integrate the new phones with a number of Microsoft products, including Zune music and video content, the Bing search engine, business products like Microsoft’s OneNote software and the Xbox gaming platform.”

Apart from possibly the Xbox, who cares? How can it be that the master of bundling now has nothing that anyone wants as part of a bundle?

There Are No Fiscal Conservatives In The United States

The Baseline Scenario » 2010 » October 10/14/10 at 8:51 AM Simon Johnson

By Simon Johnson

In most industrialized countries, attention now shifts to some form of “fiscal austerity” – meaning the need to bring budget deficits under control. In the UK, for example, there is an active debate between those on the right of the political spectrum (who want more cuts sooner) and those to the left (who would rather delay cuts as much as possible). There is a similar discussion across the European continent – although the precise terms of the debate depend on exactly which party was most profligate during the long boom of the 2000s.

The United States stands out as quite different. No one is yet seriously proposing to address our underlying budget issues. There are certainly people who claim to be “fiscal conservatives” – some of the right and some on the left – but none can yet be taken seriously. The implications are very bad for our fiscal future.

The background, of course, is that the US budget was in relatively good shape at the end of the Clinton years (culminating in a 2.5% of GDP surplus in 2000) – but turned sharply into deficit during the George W. Bush era. The headline 2% deficit in 2006, for example, perhaps did not look too bad – but it was remarkably poor performance given how well the economy was doing.

The notion that tax cuts would lead to productivity increases, thus boosting growth and in turn fixing the budget, turned out to be completely illusory. In fact, the tax cuts encouraged consumption, leading to overspending at the national level (and reflected in a current account deficit that reached 6% of GDP – this represents a big increase borrowing from foreigners by both the private sector and the government.)

But what really bust the US budget and pushed up our debt-to-GDP ratio was the way the financial system amplified the housing-based boom and bust through 2008; there were some “feel good” effects through the end of 2007, but then we faced the worst recession since World War II. Net government debt held by the private sector will increase from about 42 percent of GDP to around 80 percent as a direct result of the economic crisis – and the measures taken to prevent it from turning into another Great Depression.

([The Congressional Budget Office agrees](#) that the increase in debt-to-GDP from the crisis is about a 40 percentage point increase. [Treasury Secretary Tim Geithner has a very different](#) – and overly narrow – take, framed in terms of an assessment of TARP only: “the direct costs of the government’s overall rescue strategy are likely to be less than 1 percent of GDP.”)

The increase in our budget deficit to 10 percent in 2009 and 2010 was primarily due to our “automatic stabilizers”, meaning that the government takes in less revenue and pays people more unemployment benefit in a recession. Only 17 percent of the increase in government debt ([in the CBO baseline](#)) is due to discretionary spending of any kind. Think what you like of the fiscal stimulus (either the Bush 2008 version or the Obama 2009 effort), it is simply not the big ticket item.

If you want to fix the US budget – keeping the deficit under control and bringing down the size of our government’s debt – you have to address the risk-seeking behavior of big banks. No fiscal strategy can be credible without addressing the major problem that brought us to this point.

Of course, you can make proposals that seek to cut spending and raise revenue – see for example the recent effort [by Bill Galston and Maya McGuineas](#) from the Committee for a Responsible Federal Budget. There are some ideas here worth discussing – and they are right to put everything on the table (although I would err on the side of more comprehensive tax reform, personally). But the simple fact of the matter is that our fiscal position has been ruined by the behavior of big banks – and these banks are now free to make the same (or larger) mistakes as we head into the next credit cycle.

The unfortunate fact is that “fiscal conservatives” largely stayed on the sidelines during the financial reform debate. And the problem of “too big to fail” was absolutely not addressed adequately either by the Dodd-Frank legislation or by the subsequent Basel III framework (see [the FT’s coverage this week](#)). There is no way to handle the failure of a global megabank – the management of such banks know this and so do their creditors (see [Gillian Tett’s recent Financial Times column](#), which is exactly on target); this is carte blanche for further uncontrolled expansion of risk-taking.

In some sense this is all water under the bridge – like it or not, the reform process for systemic risk is done (and achieved little). But in that case any true fiscal conservative should recognize the risks posed by megabanks going forward and adjust their budget targets accordingly.

In particular, the commonly discussed target for our government debt-to-GDP ratio of 60 percent seems unreasonably high, given the risks posed by our financial system. We should probably aim for a target instead of 20 percent or lower, as do the most responsible emerging markets in Asia or the Baltics.

“Fiscal conservatives” (and everyone else) will likely ignore this advice. In that case, we’ll soon face a major fiscal crisis in the United States – again as a direct result of financial sector irresponsibility. Then watch your taxes go up while your social security benefits fall sharply and unemployment rises far beyond current levels.

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

Nice Economy You’ve Got There . . .

By James Kwak

That, I believe, was a line from [Nemo](#) in a comment long ago, on how the megabanks were holding the federal government hostage by threatening to collapse and take the financial system with them.

The coal industry seems to have learned something. Now that the EPA is recommending [revoking a mountaintop mining permit](#) (mountaintop mining is when, instead of drilling holes to get at coal underground, you simply blow the top off the mountain), the coal company in question has this to say:

“If the E.P.A. proceeds with its unlawful veto of the Spruce permit — as it appears determined to do — West Virginia’s economy and future tax base will suffer a serious blow.

“Beyond that, every business in the nation would be put on notice that any lawfully issued permit — Clean Water Act 404 or otherwise — can be revoked at any time according to the whims of the federal government. Clearly, such a development would have a chilling impact on future investment and job creation.”

No, every business would be put on notice a permit could be revoked for a project that “would bury more than seven miles of the Pigeonroost Branch and Oldhouse Branch streams under 110 million cubic yards of spoil, killing everything in them and sending downstream a flood of contaminants, toxic substances and life-choking algae.” Which to me seems about the right message to send.

But this is the basic position of every big corporate interest: if you don’t let us do what we want to do, the economy will suffer.

(If you want to see what mountaintop mining looks like, go to this [Google Maps mashup](#) and zoom in. It’s the big gray scars in the green mountains.)

Free Books and Board Seats

The Baseline Scenario » 2010 » October 10/16/10 at 6:55 PM James Kwak

By James Kwak

Here in the blogging world, some of us are very sensitive to the potential appearance of impropriety. A year ago, the [FTC](#) published new rules requiring bloggers to disclose cash and in-kind payments they receive for reviewing products. The upshot, for most of us, is simply that now,

when we discuss a book, we say if we got a free copy of the book from the publisher. (Although it's not clear that that disclosure is required, since getting a free copy is something that readers should expect; I don't think the *New York Times Book Review* bothers pointing out that, for every book they review, they got a free copy, although they almost certainly did.)

All the more relevant, then, is [Gerald Epstein's post](#) about conflicts of interest in the economics profession.

“Jessica Carrick-Hagenbarth and I did a study of 19 prominent academic financial economists who were members of two influential groups that have played a key role in the financial reform and regulation debate in the U.S. Of the 19 academic economists in these groups, 70% advised, owned significant stock in or were on the board of private financial institutions. But you wouldn’t know by looking at their self-identification in media appearances, policy work or academic papers.”

There are certainly economists who were talking up the housing market in the summer of 2008 without disclosing their financial ties to banks—who were desperately hoping that housing prices would not collapse.

C'mon, guys. I don't even get very many free books (maybe one per month on average—I decline most of them), and I always disclose that. I know it's not feasible to list every company that ever paid you to give a speech. But really, if you're a paid director of a bank and you write about the banking industry, can't you at least point that out?

[Once More into the Breach . . .](#)

[The Baseline Scenario](#) » 2010 » October 10/16/10 at 8:42 PM James Kwak

By James Kwak

I've been largely sitting out the foreclosure scandal/crisis. Partly I've just been too busy, and partly the coverage on other blogs has been great. Mike Konczal in particular has been providing the “beginners” posts—here's [part one](#) of five—that were my niche during the earlier part of the financial crisis, basically putting me out of a job, and [Yves Smith](#) has also been all over the issue.

I want to ask one question, but for those who are not economics blogs junkies, let me get you up to speed. It first turned out that in their haste to foreclose on houses, the law firms filing for the foreclosures (in many states, you have to get a judgment from a court in order to foreclose) were cutting corners and sometimes filing fake documents. Then it turned out that sometimes they were filing fake documents because the real ones didn't exist. In particular, it is possible that many of

the trusts that issue mortgage-backed securities never had properly-endorsed copies of the notes that underlay those mortgages. (See this [Yves Smith post](#). Highlight quote, from the CEO of a mortgage originator: “We never transferred the paper. No one in the industry transferred the paper.”)

The question is this: Why, just weeks from an election in which Democrats are probably going to get clobbered, is the Obama administration sitting on its hands, writing this off as a bunch of technicalities, and [opposing a foreclosure moratorium](#)?

Not only would it be good politics for an administration that has a hard time establishing credibility with ordinary people, but you would think a halt to foreclosures is actually what the Treasury Department wants. Over the summer, [Steve Randy Waldman](#) pointed out that Treasury essentially confirmed what many had suspected all along—the main point of HAMP (the mortgage modification program) was not to help homeowners, but to spread out the foreclosure wave over time in order to prop up housing prices and therefore protect the economy. A foreclosure moratorium, by temporarily halting the flood of foreclosed houses onto the market, would be even better.

The scary possibility is that what they’re really afraid of is systemic risk: the possibility that, as [Konczal](#) and others have pointed out, the mortgage securitization trusts (the entities that bought mortgages and issued mortgage-backed securities) could sue the investment banks, forcing them to buy back the underlying mortgages at the original cost. Since those mortgages are now worth far less than before, this would impose huge losses on the Big Six banks.

Big banks losing money isn’t what’s scary. What’s scary is that the administration may be pooh-poohing the foreclosure fraud crisis because it wants to protect the big banks once again. In other words, it’s minimizing the problem because it’s hoping that the banks will finish “reviewing their procedures,” say that everything has been fixed, and go on with their business; in that situation, it would be awkward for the administration to have come out strongly on the side of homeowners. This would basically be the operational equivalent of “it’s just a liquidity problem.”

But why? If this really could damage the big banks, why not let them take the hit and clean up afterward—especially if “orderly liquidation authority” is really the bazooka they claim it is? Why protect them now after being stabbed in the back repeatedly during the financial reform debate and in the current campaign finance cycle? Why not take this opportunity, if there really is one, to undo the mistakes of 2009?

Let’s hope there’s a better explanation than “we have created [our biggest banks], and we’re sort of past that point, and I think that in some sense, [the genie’s out of the bottle](#).”

By James Kwak

Adam Levitin and Susan Wachter have written an excellent paper on the housing bubble with the somewhat immodest title, “[Explaining the Housing Bubble](#)” (which has been sitting in my inbox for a month). My main complaint with it is that it’s eighty-one pages long (single-spaced), which is most likely a function of law review traditions; had it been written for economics journals, it could have been one-third the length. I also have some quibbles with the seemingly obligatory paean to the importance of homeownership, which I think is an assumption that deserves to be contested. But overall it presents both a readable overview of the history and the issues, and a core argument I have a lot of sympathy for.

The argument is that the motive force behind the credit bubble was an oversupply of housing finance—in other words, the big, bad, banking industry. Levitin and Wachter’s key evidence is that the price of residential mortgage debt was falling in 2004-06 even as the volume of such debt was rising. As Brad DeLong’s parrot would say, that can only happen if the supply curve is shifting outward, not if the demand curve is shifting outward (which is what would happen if it were all the fault of greedy borrowers who wanted to flip houses).

This oversupply of housing finance happened because of banks’ desire to keep the securitization pipeline flowing after the 2001-03 refinancing wave tapered off. Private mortgage-backed securities were their preferred instrument because they are both complex and heterogeneous: complexity means they are impossible to price based on fundamentals, and heterogeneity means that comparing prices between private MBS is meaningless or misleading. And this was possible because there were no regulatory standards governing the private MBS market. The “market regulation” beloved of Alan Greenspan also didn’t work because, among other things, short pressures were soaked up by synthetic CDOs that were willing to sell CDS protection on MBS at artificially low prices.

A lot of the story will be familiar to financial crisis junkies, but you will probably learn something new (about the difference between the CMBS and RMBS securitizations, for example). And most importantly, with all the misinformation floating around about the causes of the crisis, Levitin and Wachter isolate the importance of our deeply flawed financial system.

[An Early Stress Test For The Financial Stability Oversight Council](#)

By Simon Johnson

How much damage to the financial system should we expect from what is now commonly called the foreclosure morass, the still-developing scandal involving document robo-signing (and robo-dockets), completely messed up mortgage paperwork and high-profile inquiries into accusations of systematic and deliberate misbehavior by banks?

The damage to banks' reputation is immeasurable. They have undermined property rights – the ability to establish clear title is a founding idea of the American republic. They have mistreated customers in a completely unacceptable manner. If anyone doubted the need for a new consumer protection agency dealing with financial products – and the importance of having a [clear-thinking reformer like Elizabeth Warren](#) at its head – they are presumably silenced by recent events. (If you need to get up to speed on the basics of this issue, see this [series of posts](#) by Mike Konczal.)

But what is the cost in terms of additional likely losses to big banks? The likely size and nature of these are leading to exactly the kind of systemic risks that the Financial Stability Oversight Council was recently established to anticipate and deal with.

It is hard to know how the precise numbers for losses will end up, so much uncertainty remains about the basic parameters of the foreclosure problem. A lot of smart people are looking for ways to sue the big banks – in particular to force them to take back (at face value) securities that were issued based on some underlying degree of deception.

This is a fast-evolving situation in which every day brings potentially significant news, but our baseline view is that the losses are in the range of \$50 billion to \$100 billion – that is, these are “new” losses not yet recognized by banks. (Our downside scenario, with perhaps a 10 percent probability, is that the losses are much larger.) Most of this is so-called putbacks to the banks from Fannie Mae and Freddie Mac, meaning that the banks are forced to take back on to their books the underlying securities (and absorb the associated losses) if there was significant misrepresentation in the original documentation.

In almost all scenarios, these additional losses will remain an order of magnitude smaller than the trillions of dollars in credit losses that brought down the global financial system in 2008-9. Still, these latest losses are not helpful to confidence in big banks, and the continuing uncertainty – which is entirely the banks’ own fault – will make their managements more cautious about extending new credit.

Capital is the buffer that banks hold against losses, and banks really do not want to raise more capital under current conditions. Their executives’ fear about potentially having insufficient capital will further undermine loan availability, even for creditworthy borrowers. This is exactly what the economic recovery does not need.

In addition, Bank of America is a particular worry, because its capital position is already precarious and any downgrade by rating agencies will push it into dangerous territory. To the extent the

market believes that the government does not stand fully or immediately behind Bank of America (a view expressed by Morgan Stanley analysts in a note this week), we should expect pressures reminiscent of fall 2008. We [also learned yesterday](#) of sizable additional potential exposure from the lawsuit filed by the Federal Reserve Bank of New York, PIMCO and BlackRock — seeking to force Bank of America to buy back bad mortgages packaged into \$47 billion of mortgage-backed securities issued by Countrywide.

The best approach would be a fresh set of stress tests, resulting in the requirement that Bank of America and perhaps other banks need to raise a specified dollar amount of capital (not hit a particular capital-asset ratio, as that would just result in further dumping of assets), and reassuring the market that other banks have sufficient capital, including under the augmented [Basel III](#) requirements. (For a primer on capital requirements and the thinking that underlies the approach we are recommending, see [our post](#) of Oct. 7.)

Created by the [Dodd-Frank](#) financial regulatory act, the Financial Stability Oversight Council has plenty of power to order and organize such stress tests. In fact, because of the powers granted to the council under the [Kanjorski Amendment](#), the country's top regulators have a complete menu of choices available in terms of what they can require banks to do in order to reduce risks to the system (up to and including preemptively breaking up big troubled banks).

The foreclosure morass clearly poses systemic risk, both through its general effects on uncertainty about losses and because any manifest weakness at one big bank could spread — in some obvious ways and in some unanticipated ways — through the rest of the system.

In addition, the stress tests of 2009 (known as the Supervisory Capital Assessment Program) did not consider the possibility of large losses arising from the litigation now surrounding mortgage-backed securities. When Representative Brad Miller, Democrat of North Carolina, asked Treasury Secretary Tim Geithner about this at a House Financial Services Committee hearing on Sept. 22, the exchange went like this:

MILLER, asking about possible breach of contract in securitized mortgages: Okay. was potential liability on these theories taken into account at all in the stress test? I mean, the securitizers, who presumably would be the defendants in any litigation, are the 19 biggest banks that got the stress tests, was their potential liability taken into account at all in the stress tests a year ago?

GEITHNER: I...I don't think so....

Mr. Geithner also said he would take this question up in more detail with his colleagues at the Federal Reserve, which administered the 2009 stress tests. The exchange can be heard in full [online](#), with the Miller-Geithner exchange at about the 42-minute mark.

The only fair, reasonable, and safe way to handle this situation is to order a fresh round of stress

tests for all systemically important financial institutions. The stress scenario should consider not just the current dismal macroeconomic prognosis (and the potential for another slip back into recession) but also the downside with regard to litigation losses.

If the Financial Stability Oversight Council refuses to act decisively in this regard, a vital piece of the Dodd-Frank financial reforms will have failed.

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

Food and Finance

The Baseline Scenario » 2010 » October 10/24/10 at 4:09 PM James Kwak

By James Kwak

I just read Michael Pollan's book, *In Defense of Food*, and what struck me was the parallels between the evolution of food and the evolution of finance since the 1970s. This will only confirm my critics' belief that I see the same thing everywhere, but bear with me for a minute.

Pollan's account, grossly simplified, goes something like this. The dominant ideology of food in the United States is nutritionism: the idea that food should be thought of in terms of its component nutrients. Food science is devoted to identifying the nutrients in food that make us healthy or unhealthy, and encouraging us to consume more of the former and less of the latter. This is good for nutritional "science," since you can write papers about omega-3 fatty acids, while it's very hard to write papers about broccoli.

It's especially good for the food industry, because nutritionism justifies even more intensive processing of food. Instead of making bread out of flour, yeast, water, and salt, Sara Lee makes "Soft & Smooth Whole Grain White Bread" out of "enriched bleached flour" (seven ingredients), water, "whole grains" (three ingredients), high fructose corn syrup, whey, wheat gluten, yeast, cellulose, honey, calcium sulfate, vegetable oil, salt, butter, dough conditioners (up to seven ingredients), guar gum, calcium propionate, distilled vinegar, yeast nutrients (three ingredients), corn starch, natural flavor [?], betacarotene, vitamin D3, soy lecithin, and soy flour (pp. 151-52). They add a modest amount of whole grains so they can call it "whole grain" bread, and then they add the sweeteners and the dough conditioners to make it taste more like Wonder Bread. Because processed foods sell at higher margins, we have an enormous food industry pushing highly processed food at us, very cheaply (because it's mainly made out of highly-subsidized corn and

soy), which despite its health claims (or perhaps because of them) is almost certainly bad for us, and bad for the environment as well. This has been abetted by the government, albeit perhaps reluctantly, which now allows labels like this on corn oil (pp. 155-56):

“Very limited and preliminary scientific evidence suggests that eating about one tablespoon (16 grams) of corn oil daily may reduce the risk of heart disease due to the unsaturated fat content in corn oil.”

With this fine print disclaimer:

“FDA concludes that there is little scientific evidence supporting this claim. To achieve this possible benefit, corn oil is to replace a similar amount of saturated fat and not increase the total number of calories you eat in a day.”

Unfortunately, nutritionism is pretty much bogus science. The major claim of nutritionism over the past thirty years—that fat is bad for you—turns out not to have any foundation at all.*

What does this all have to do with finance? Roughly speaking, read academic finance for nutritionism; the financial sector for the food industry; subprime loans, reverse convertibles, and CDOs for highly processed food claiming to improve your health but actually killing you; current disclosure laws for the FDA-approved health claims on corn oil; thirty-year fixed-rate mortgages and index funds for the neglected, unsubsidized, unadvertised fruits and vegetables in the produce section; the OCC and OTS for the FDA; and the long-term increase in obesity and diabetes for the long-term increase in household debt.

In both cases, you have an industry that earns profits by convincing people to do things that are not in their long-term interests; that, in the process, creates negative externalities for the rest of society; and that has cowed regulators into submission, if not outright cheerleading. In both cases, the industry defends itself from critics by saying that it is simply providing what customers want, and hence any new constraints (even, say, accurate organic labeling laws) constitute a paternalistic intrusion into people’s economic freedom. And in both cases, the industry claims that if it isn’t allowed to continue on its current course, the economy as a whole will suffer. (After all, our corn- and soy-based diet is what enables the industry to provide huge numbers of calories at low cost.)

One big difference is that when it comes to the food system, there is a fair amount you can do to protect yourself and your family from its unhealthy effects (if you have the money). With the financial system, it’s a bit harder.

* It’s a bit more complicated than that, so before you take this as advice, read Part I, Chapter 5.

By James Kwak

We appear to be a week way from an election that, while really about persistent high unemployment, on the talking-point level is largely about deficits, with the Republicans continuing their usual posturing about cutting deficits without raising taxes or explaining what spending programs they are going to cut. [Robert Pollin](#) has contributed an analysis of the deficit hawks' argument that is valuable for pointing out that there actually four deficit hawk arguments. In his words:

“1. The traditional view. Large fiscal deficits will cause high interest rates, large government debts, and inflation.

“2. Declining business confidence is the real danger. Even if the current deficits have not caused high interest rates and inflation, they are eroding business confidence. When business confidence is low, the economy is highly vulnerable to small changes in conditions, what some economists call ‘non-linearities.’

“3. Fiscal stimulus policies never work. New Classical economists, Robert Barro most notably, have long argued that the multiplier for fiscal stimulus policies is zero or thereabouts.

“4. A long-term fiscal train-wreck is coming. Regardless of short-term considerations, we are courting disaster in the long-run with structural deficits that the recession has only worsened.

Pollin also has the grace to point out that, for the deficit hawks to be correct, only one of these arguments has to be correct.

Of course, they're not, at least not the first three. To the first argument, Pollin largely follows the Krugman line, pointing out that interest rates and inflation remain stubbornly low, with the risk of deflation outweighing the risk of inflation. With excess capacity and high unemployment, it's hard to see what private sector investment there is for the government to crowd out.

The second argument is the one popularized by Carmen and Vincent Reinhart and Ken Rogoff. Its appeal is that it bypasses the Krugman argument (interest rates are low, not high) by hypothesizing that at some point, investor sentiment tips and interest rates suddenly skyrocket. Now, this is certainly true *at some point*, and given the limited data (there just aren't that many countries in the history of the world with our economic influence and control over the world's reserve currency), there is no trustworthy empirical answer to the question of when confidence crumbles away. But I'm with Pollin on this one. Why panic over an unquantifiable risk of an unquantifiable tipping point

when (a) there are no data saying we're close to one and, more importantly, (b) we know there is a very real risk of economic stagnation? Not only is there a risk of stagnation, we have stagnation right now—just ask all the people without jobs. In the long term, confidence in the ability of the Treasury to pay off its debts is based on expectations about the future performance of the U.S. economy (since the economy is the tax base), and the bigger worry right now should be economic growth.

The third argument is the old one about multipliers, and the short answer is that the vast majority of the empirical work says that multipliers are positive, even for tax cuts, and multipliers for spending are often over one (see Blinder, Zandi, Chinn, et al.).

The fourth argument is the one where I think the deficit hawks might have a point, although their usual solutions (austerity now!) are wrongheaded. Pollin's rebuttal is that the average fiscal deficit over the next decade is projected by the CBO at 5.2% of GDP (using the administration's proposed budget, which includes extending most of the Bush tax cuts), and we can easily get that down to 2-3% of GDP through some combination of lower health care costs, lower military spending (e.g., just getting somewhere close to 2000 levels), and a financial transaction tax. I think he's basically right as far as the next decade goes, but after 2020 the problems with Medicare start to take off, and those problems are largely outside the government's control: Medicare is just an insurance plan to pay for privately delivered services, and those services are what is skyrocketing in price. So this gets into the debate about how much the recent health care reform bill actually reduced long-term health care costs, which is a messy and as yet unresolved debate.

But as I've said before, if you take argument #4 seriously, the answer has to be curbing the long-term growth of healthcare costs, not cutting government spending now, which is basically irrelevant to the "structural" deficit and, worse yet, will only worsen and prolong the recession.* And the answer has to be curbing healthcare costs in general, not just the government's share of those costs, because otherwise you're just shifting the risk onto people who cannot afford to bear it.

* From now on, I'm not going to bother pointing out that, according to the NBER, the recession ended a year ago. You know what I mean.

Beyond Crazy

The Baseline Scenario » 2010 » October 10/27/10 at 7:00 AM James Kwak

By James Kwak

[Daniel Hamermesh](#) points out a [Wall Street Journal](#) article on how colleges and universities are trying to increase accountability and productivity by measuring costs and benefits quantitatively.

The “star” example is Texas A&M, which created a report showing a profit-and-loss summary for each professor or lecturer, where revenues are defined as external grants plus a share of tuition (if you teach one hundred students, you are credited with ten times as much revenues as someone who teaches ten students).

Let’s not argue about whether our colleges and universities are doing a good job. Let’s not even argue about whether we need more transparency and accountability in higher education. Assuming we do, this is just about the most idiotic way of doing it that I could imagine. No, wait; there’s no way I could have imagined something this stupid.

The “professor P&L” is an attempt to bring private-sector “efficiency” into higher education, but I can’t believe anyone who actually worked in the private sector could think this could work. At my company, we* thought a lot about the problem of software productivity and how to measure it. And the problem is, there really is no way to do it on an individual level. Measuring lines of code is crazy, because ideally you want to solve a given problem in as few lines of code as possible. Measuring classes or methods is equally crazy. Measuring what some people call “function points” is crazy, because they depend on what you call a function point. Most fundamentally, measuring quantity of output is crazy, because quality is much, much, much more important than quantity. It’s better to write a little bit of software well, in a way that doesn’t break anything else, can be tested reliably, and can be expanded on in the future, than to write a lot of software badly. So instead, we look at whether the software does what it is supposed to do, whether it can be tested, and whether it does what our customers want it to do. That’s how the private sector works.

And if you can’t measure software productivity, how are you going to measure educational productivity, which is much more complicated? What is the unit of output you are going to measure? More fundamentally, what is the output you are trying to produce?

What is Texas A&M measuring? The fact that you are teaching someone—not what you are teaching, or how well. In some fantasyland, you might think that the “free market” for college classes will make students flow toward the professors who teach useful things well. As anyone who has ever gone to a university knows, however, students flow toward (a) required courses and (b) professors who give easy grades. And they are measuring the grant dollars you bring in, not what you do with those grant dollars. So, for example, computer science will do worse than mechanical engineering, simply because it is less capital-intensive.

If you’re going to measure outputs, the places to look are whether students graduate from college knowing things, whether they are satisfied with their educations, and whether they are able to do the jobs employers need them to do. We could have a reasonable debate about whether those things can be measured, and whether they are worthwhile to measure. There is a lot of evidence that this kind of testing has harmful unintended consequences at lower levels, and it seems even more inappropriate for college, but that’s something that could be debated and tested.

So where did this idea come from? The Texas Public Policy Foundation, a conservative think tank. Apparently they didn't even finish first-semester economics. They got the bit about how market forces are driven by profits and losses. But they missed the bit about why markets work: markets only increase social welfare if the prices of things reflect their value, not if they are completely artificial.

* By "we," I mainly mean other people at the company.

[Who's In Charge Here? Not The G20](#)

[The Baseline Scenario » 2010 » October](#) 10/28/10 at 6:14 AM Simon Johnson

By Simon Johnson

Most accounts of the ministerial meeting last weekend of the Group of 20 — 19 nations plus the European Union that represent the world's wealthiest economies — implied that it continued to perform sterling service — heading off currency wars, keeping explicit protectionism under control and deftly managing the process of reforming governance at the International Monetary Fund.

Post-financial crisis, middle-income countries continue to rise in economic importance, and the recent shift in global leadership from the Group of 7 (the United States, Canada, Britain, Italy, France, Germany and Japan) to the G-20 is commonly supposed to accommodate the growing claims of "emerging markets" on the world stage.

This interpretation is correct as far as it goes, but it also misses the main story, which is that emerging markets have two primary goals that are increasingly at odds with each other. These goals — to hold large stocks of American dollars and to stave off a flow of capital from abroad — add up to wanting to retain the emerging markets' recently achieved status of collective net creditors (i.e., being owed more than they owe). Unfortunately, this contributes to the serious vulnerability of the world economy as we head into the next credit cycle.

Emerging markets want to hold onto — or increase further — the vast stock of foreign exchange reserves that they have recently accumulated through current-account surpluses. In part these assets are a buffer against future shocks, but the countries now hold much more than they would need for purely precautionary purposes — China alone acknowledges holding around \$2.5 trillion, much of which is presumably in American dollars.

Increasingly, emerging markets think about using the value of these reserves (or what they could buy with them) in a broader manner. They enjoy the status and power that comes with being a net

creditor to the system – rather than a net debtor, as in the past (which involved periodic crises, loans with unpleasant conditions from the International Monetary Fund and having to be deferential to the United States when times were tough and so on).

They even begin to think about forming the basis for a new monetary arrangement that is less dependent on the dollar – since the 2008 financial crisis, both the [Russians](#) and [Chinese](#) have spoken in public about this objective, and it is shared in private by most policy-makers outside Europe and the United States.

The “reserve currency” status of the dollar means just that – private and public sector investors around the world hold their rainy-day funds in dollars. Traditionally, at least, this arrangement has been seen as a major economic advantage and source of political power for the United States.

Emerging markets want to discuss moving reserves into a basket of currencies, presumably involving some Chinese renminbi, Indian rupees, Russian rubles and Brazilian reals (the four Rs), among other currencies.

But this is where tension with the second goal enters the picture. Most emerging markets – including those with the four Rs – do not want to allow their currencies to appreciate, and they are also unwilling to take other measures (like cutting fiscal spending) that would be likely to hold back appreciation in some instances (Brazil, in particular, takes this stance). Instead they are imposing capital controls to prevent inflows.

The controls are unlikely to prove fully effective, but they do slow the appreciation for now – and they also send a very clear signal: Foreign investors will be treated at a differential disadvantage when the chips are down.

Ask an Indian executive whether she is thinking about investing in Brazil and the answer is an unequivocal yes. But ask whether she or her policy-making colleague would like to hold reserves in *reals* and the answer is also quite frank: no, thank you.

Emerging markets will continue to save for a very rainy day (or a bright unspecified future) – in dollars. They intervene to keep their exchange rates relatively depreciated and will try to run current-account surpluses for as long as they can. This behavior pushes down long-term interest rates in the United States, relative to what those would be otherwise.

And – here’s the kicker – very low interest rates in the United States contrast sharply in the minds of yield- and risk-seeking investors with the situation in Brazil, where you are now offered 11 percent interest rates.

In other words, the global credit machine in this part of its cycle takes savings from emerging markets, runs them through the United States, and – at the margin – plows them back into emerging markets. Dollars are bought up through central bank intervention and – you guessed it –

funneled back into the United States. The Institute for International Finance, which represents global banks, just [revised upward](#) its estimate of capital flows into emerging markets this year.

This is exactly the kind of issue – inherently cross-border and very political – for which a structure like the G-20 is needed. But it will do nothing about these flows for three reasons:

1. The emerging markets want to save in this fashion, thinking they can dodge the consequences.
2. The United States needs to borrow, big time. Our politicians [refuse even to think](#) about the first-order causes of our recent fiscal disaster; they would rather just continue to borrow (at least as long as interest rates remain low).
3. The big banks like this approach. Their influence is in no way diminishing, and there is nothing about their recent track record that has diminished their appeal in the eyes of policy-makers (just this week, for example, the I.M.F. appointed a [senior Goldman Sachs executive](#) to head its high-profile European Department).

Accommodating emerging markets in global governance structures is appealing; their aspirations are legitimate, and the G7 looks outmoded. The profound instability of global financial structures and the broader “doom cycle” today is not the fault of emerging markets – the blame lies squarely with the United States and Western Europe, which have consistently failed to rein in their global megabanks. (For an 8-minute primer on the “doom cycle,” if you are not familiar with the concept, [try this video](#).)

The argument that [the global savings glut](#), largely from emerging markets, was a major driver of the 2008-9 crisis is tenuous at best. But there is no question of a dissonance within the current policy goals of emerging markets – and this is not helpful to financial stability moving forward. Most likely it helps feed – or otherwise becomes central to – the next financial frenzy. And there is nothing the G-20 can or will do about it.

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

Telecom Tech Support

The Baseline Scenario » 2010 » October 10/28/10 at 9:46 AM James Kwak

By James Kwak

I've recently been making you suffer through my [struggles](#) with the [telecom industry](#). To show that I appreciate your patience, I wanted to recommend to you a [brilliant cartoon](#) on telecom tech support, from the inimitable XKCD. I would reproduce it here, but that seems like it would violate

fair use, so you'll have to go [over there](#).

Don't forget to check out the mouseover (place your pointer over the cartoon and wait for a few seconds).

Foreign Money, National Security, And The Midterm Elections

The Baseline Scenario » 2010 » October 10/31/10 at 8:41 AM Simon Johnson

By Simon Johnson

Campaign contributions by non-citizens are a huge issue lurking behind the midterm elections; they will be even more important in 2012. Think about the economic dynamics:

1. Americans have a long-standing and well-founded aversion to foreign involvement in their politics, and it is well-established that this can happen in part through corporate "commercial" structures. Thomas Jefferson objected to Alexander Hamilton's plan for a national bank in part because he feared this would become a stalking horse for the British in some form (see Chapter 2 of [13 Bankers](#) for the context). [Dubai Ports World](#) was not allowed to invest in the United States – for reasons of perceived national security. You may or may not think that case was handled well, but we have the [CFIUS process](#) to vet foreign direct investment for good reason.
2. The [Supreme Court has determined](#) that corporations can make political contributions virtually without limit, apparently not understanding or not caring that (a) management has a [fiduciary responsibility](#) to shareholders, (b) globalization means more foreign shareholders on average (for privately held companies and funds, as well as publicly traded companies), and (c) at the margin, key strategic shareholders – the people who provide extra capital when the chips are down – increasingly tend to be foreign. Think about the role of [Sovereign Wealth Funds](#) in providing funds to our banking system in 2007-08, or the fact that Citigroup goes cap-in-hand to Saudi Arabia every decade or so.
3. During the Reagan years and again, even more, under the Second President Bush, the US ran a [large current account deficit](#) – reaching 6 percent of GDP before the 2008 crisis (and still around 3 percent of GDP). You may think this a technical detail that is largely irrelevant to the political process, but you would be wrong. We finance our current account deficit with capital inflows from abroad or, to put that more plainly: Foreigners buy and hold financial assets in the United States. Some of those assets are US government obligations but traditionally and increasingly non-US people have also acquired claims on corporate entities – including common or preferred stock.

There are good economic reasons to allow foreigners to buy financial assets in the United States. We like to invest around the world and a high degree of reciprocity is only reasonable.

The US dollar is the “[reserve currency](#)” of choice – for the past 50 years this is where countries and careful individuals have chosen to keep their rainy day funds. This was a core idea behind the international trading system constructed after 1945. You may not like it, but what alternative exactly would you propose?

And there is nothing wrong per se with running a current account deficit – although it would be much better if we used the inflow of foreign capital to finance investment, rather than (as in the Bush years) tax cuts that just further encourage overconsumption.

Irrespective of how you feel about foreign capital inflows in economic terms, you have to face the political reality. As foreigners accumulate claims on the United States, they will increasingly diversify into corporate assets (in fact, this is the advice they get from their Wall Street advisers). Some of these corporate assets explicitly come with voting rights – but those are supposed to be voting rights over the corporation (or investment fund), not voting rights in political elections.

We have effectively enfranchised foreigners in US elections. This is clearly and absolutely not what the drafters of the Constitution had in mind.

This dissonance between our claimed political values and the political reality will grow over time – unless you think our current account deficit will swing into surplus at any time in the future, the net inflow of foreign capital will continue.

The only way to deal with this is to require complete disclosure by all corporate entities (and similar “veils” like investment funds of any kind) regarding the contributions they make to any organization or individual involved in political messaging or campaigning.

To be sure, this would be onerous. Thomas Jefferson and his colleagues would have wanted it no other way. The US Constitution was not drawn up to protect the rights of foreign citizens. It defines who is and who can become an American – and the rights and responsibilities of those who would like to rule the United States.

And however you prefer to define our legitimate national security interests, how are they consistent with letting foreign citizens influence or even determine the outcome of our elections?