

By Simon Johnson

The big question of the week in Europe is deceptively simple – will any countries that share the euro as their currency default on their government or bank debts in the foreseeable future? The answer to this question determines how you regard bonds from countries such as Portugal, Spain, Italy, and Belgium.

Answering this question is not as simple as it seems, however, because it involves taking a view on three intricate issues: What exactly is the eurozone policy now on bailouts, can big eurozone countries really be bailed out if needed, and what happens to the politics of these countries and of the eurozone has a whole as pressure from the financial markets mounts?

The prevailing consensus – and definite official spin – is that over the weekend European leaders backed away from the German proposal to impose losses on creditors as a condition of future bailouts, i.e., from 2013. The markets, in this view, should and likely will calm now; there is no immediate prospect of any kind of sovereign default or (more politely) “reprofiling” on debt, including the obligations of big banks.

But a close reading of the Eurogroup ministers’ statement from Sunday suggests quite a different interpretation. It’s a straightforward text, [just 2 ½ pages long](#), but it has potentially momentous consequences – as it envisages dividing future eurozone crises into two kinds.

“For countries considered solvent, on the basis of the debt sustainability analysis conducted by the [European] Commission and the IMF, in liaison with the ECB [European Central Bank], the private sector creditors would be encouraged to maintain their exposure according to international rules and fully in line with the IMF practices. *In the unexpected event that a country would appear to be insolvent, the Member State has to negotiate a comprehensive restructuring plan with its private sector creditors, in line with IMF practices with a view to restoring debt sustainability.* If debt sustainability can be reached through these measures, the ESM [European Stability Mechanism] may provide liquidity assistance.” (from the middle of p.2; emphasis added)

Translation: if it is decided your country is “insolvent”, rather than illiquid, then you have to restructure your debts. But who exactly will decide? Look at the preceding one line paragraph in that document (again on the middle of p.2) for the bombshell.

“On this basis, the Eurogroup Ministers will take a unanimous decision on providing assistance.”

In other words, any one member of the eurozone can veto a country being determined merely illiquid – thus cutting them off from cheap and endless credit (from the ECB or ESM or any window to be named later). So now Germany effectively has a veto – as do other fiscally austere countries including Estonia (from January 1st when it becomes the 17th member of the eurozone.)

Most likely we will witness the creation of an Austere Coalition (actually a modified [Hanseatic League](#)) of Germany, Austria, Finland, Estonia, and a few of the smaller countries. Ending moral hazard – the prospect of soft bail out money forever – is an admirable goal. But getting there under current conditions is going to be rocky because that new regime implies countries need to have less total debt and a longer maturity on their debt than they do now. Transitional arrangements have not been put in place – other than the ad hoc sequential bailouts that we now see unfolding.

As for the resources needed to “bail out” countries now facing market pressure, the IMF and EU combined definitely have enough money in hand to help with Portugal and Spain – if this becomes necessary. But they do not have enough funding currently to deal with Italy, Belgium and other larger countries (if there is a sequence of crises in the year ahead).

The IMF can, in principle, raise further resources beyond what it already has in hand; its membership (and effective owners) includes almost all countries in the world. IMF resources are shrouded in jargon; here is a [relatively clear recent statement](#) – bottom line: the IMF has no more than \$1 trillion, but in terms of usable cash, the experts start to look pale as you discuss committing more than \$500bn.

But in the US this would involve a very awkward conversation with the Republican House of Representatives, among others. Who else around the world has a stock of hard “convertible” currency sufficiently large to make a difference? [The call list](#) for the IMF’s Managing Director is short: China, Abu Dhabi, Saudi Arabia and perhaps Singapore, Russia, and a few others. This is not an easy scenario for anyone.

The IMF could also create its own money – known as [Special Drawing Rights](#). Again, check with your elected representative and the head of your central bank to see how they feel about this. No one wants a global central bank that would operate without the prospect of proper political oversight.

The 27-member European Union could come up with further resources for itself. But this would involve more taxes for the fiscally sound parts of the eurozone, including Germany. And at some point soon the German taxpayer may decide enough is enough – which is exactly where the terms around the ESM come into play.

The euro is also a “reserve currency”, meaning that other countries like to use it for their precautionary savings. Again, in principle the European Central Bank could create enough new money to enable all indebted governments to discharge their debts in full. No one wants to contemplate the inflationary consequences of that.

In short, the larger European countries are “too big to bail”.

But do they really need a bailout or are we just looking at a “run on sovereign debt” or pure financial panic in Western Europe?

There are definitely elements of a panic at work but keep in mind one important point – such runs

can become self-fulfilling, i.e., they create the exact conditions that started people worrying in the first place.

In fall 1997 in Indonesia, for example, financial markets began to worry about the collapse of the Suharto regime. Initially, this seemed farfetched – after all Suharto had been in power for more than 30 years. But the rapid depreciation of the rupiah put great pressure on the Indonesian corporate sector, which had borrowed heavily in dollars, and this contributed to undermining Suharto politically. After many twists and turns, Suharto fell. (As always, I recommend Paul Blustein's book, [*The Chastening: Inside the Crisis That Rocked the Global Financial System and Humbled the IMF*](#); Blustein is the Michael Lewis of international finance.)

The market proved itself right in the sense that dramatically lower asset prices reduced perceived legitimacy of the regime and generated a great deal of political uncertainty. This uncertainty justified the fall in asset prices.

Could something similar happen in Europe today?

Just as for Asia in September 1997, such a sequence of events does not seem very likely, but there is no question that European domestic and regional political institutions are undergoing a severe stress test.

Whose coalitions will collapse? Where will governments prove unable to stay the course on fiscal policy? And, at the end of the day, whom do the Germans trust enough to provide with unlimited financial backing?

Governance in Asia did not change in 1997 – there were long-standing issues with the way companies operated (chaebol in Korea, family firms in Thailand) and with the relationship between the state and business (Suharto's family in Indonesia). During the boom, investors did not particularly worry about what this implied.

But when downturn comes – in Asia's case with a rapid depreciation of currencies; in Europe's case it is a crisis of confidence in "investment grade" debt – governance becomes a salient question for everyone who can move money.

The biggest issue today is not how Europe could be governed in some future ideal world, but rather how it is governed – and how any misgovernance will play out and be perceived as the pressures now really begin to mount.

An edited version of this post [appeared 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.

By Simon Johnson

In Sunday's New York Times magazine, [Roger Lowenstein profiles Jamie Dimon](#), head of JP Morgan Chase. The piece, titled "Jamie Dimon: America's Least-Hated Banker," is generally sympathetic, but in every significant detail it confirms that Mr. Dimon is now – without question – [our most dangerous banker](#).

Mr. Dimon is not dangerous because he is in any narrow sense incompetent. On the contrary, Mr. Dimon is very good at getting what he wants. And now he wants to run a bigger, more interconnected, and more global bank that – if it were to fail – would cause great chaos around the world. Lowenstein writes,

“Dimon has always been unusually blunt, and he told me that not only are big banks like JP Morgan (it has \$2 trillion in assets) not too big, but that they should be allowed to grow bigger.”

The problem with very big banks is not that they are “too big to fail,” in the sense that it is physically impossible for them to fail. It is that they are so large and therefore so connected with each other — and with all aspects of how the modern economy operates — that the failure of even one such bank would cause great damage throughout the world.

Lehman Brothers had a balance sheet of around \$600 billion when it failed. Its collapse helped trigger the worst financial crisis and deepest recession since the 1930s. Imagine what would happen if JP Morgan Chase – even at today's scale – were allowed to go bankrupt.

Dimon is brilliantly disingenuous on this key point.

“No one should be too big to fail,” he tells me. And J. P. Morgan? “Right,” he says. “Morgan should have to file for bankruptcy.”

But Dimon himself argued, in [a November 2009 op ed in the Washington Post](#), that regular bankruptcy is not a feasible option for megabanks. Instead he eloquently advocated the creation of a special resolution mechanism for big banks – an update and expansion of the powers that the FDIC has long used to handle the orderly failure of small and medium-sized banks with insured retail deposits.

“Creating the structures to allow for the orderly failure of a large financial institution starts with giving regulators the authority to facilitate failures when they occur. Under such a system, a failed bank's shareholders should lose their value; unsecured creditors should be at risk and, if necessary, wiped out. A regulator should be able to terminate management and boards and liquidate assets. Those who benefited from mismanaging risks or taking on inappropriate risk should feel the pain. We can learn here from how the Federal Deposit Insurance Corp. closes banks. As with the FDIC process, as long as shareholders and creditors are losing their value, the industry should pay its fair share.”

Unfortunately, the resolution authority that ended up being created by the 2010 Dodd-Frank financial reform legislation does not cover JP Morgan Chase because Dimon's bank operates so extensively outside the US (30% non-US in its current business, on its way to 50%, according to Lowenstein). [There is nothing in the current resolution mechanism](#) or the broader powers of the Financial Stability Oversight Council that enables the relevant authorities to implement the orderly winding down of a cross-border bank, like JP Morgan is today or Lehman was in 2008.

And there is no prospect of any kind of inter-governmental agreement to put in place a process for imposing orderly and foreseeable losses on the creditors to cross-border bank. In fact, the Basel Committee of bank regulators, which has jurisdiction in this matter – and which Dimon praises in the NYT interview –has definitely decided not to take up the issue.

JP Morgan Chase is already Too Big To Fail. If it were to threaten failure, the government would face a terrible choice: provide some form of unsavory bailout, i.e., fully protecting creditors; or risk the outbreak of a Second Great Depression. While the executive branch pondered these alternatives, there would be global financial panic.

But that is not the worst of our worries. Jamie Dimon is apparently dead set on ensuring JP Morgan Chase becomes even larger, in part by expanding its operations in emerging markets in India, China, and elsewhere.

As Ireland and other European countries have recently discovered to their horror, Too Big To Fail banks that want to expand globally can grow so large that they become Too Big To Save. “Too Big To Save” means that the government wants to save the bank – e.g., by providing a blanket guarantee, as the Irish did in October 2008 – but that creates such a large liability for the state that it pushes the entire country into insolvency.

JP Morgan Chase is well on its way to becoming Too Big To Save. Through expanding overseas, it effectively bypasses the weak controls we still have in place on bank size (no bank is supposed to have more than 10 percent of total retail deposits). Experience in Europe is that this strategy can enable individual banks to build balance sheets that are larger than the GDP of the country in which they are based – in the UK, for example, the Royal Bank of Scotland had a balance approaching 1.5 times the size of the British economy. And then it failed.

If JP Morgan Chase were to reach the equivalent size in the US, it would be a \$20 trillion bank. Perhaps that would take a while, but JP Morgan Chase soon at \$4 trillion or \$8 trillion is easy to imagine.

Dimon argues that banks becoming bigger is the natural outcome of market processes. He is completely wrong – as Thomas Hoenig, president of the Kansas City Fed explained [in a NYT op ed this week](#):

“These firms [big banks] reached their present size through the subsidies they received because they were too big to fail. Therefore, diminishing their size and scope, thereby reducing or removing this subsidy and the competitive advantage it provides, would restore competitive

balance to our economic system.” ([See also this news coverage](#) on Hoenig’s views.)

Or listen to Gene Fama – the father of the modern “efficient markets” view of finance. [He told CNBC](#) that Too Big To Fail banks are “perverting activities and incentives”, giving big financial firms,

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

Or read the recent [letter to the Financial Times](#) by Anat Admati and other top names in academic finance (here’s the version of [their text on the Stanford website](#)). They could be speaking directly of Dimon and his views in the NYT piece when they say:

“Many bankers oppose increased equity requirements, possibly because of a vested interest in the current systems of subsidies and compensation. But the policy goal must be a healthier banking system, rather than high returns for banks’ shareholders and managers, with taxpayers picking up losses and economies suffering the fall-out.” (See also Professor Admati’s follow up letter to the FT this week, [further blasting the views of top bankers](#) and their acolytes; see this link for a version not behind the FT wall: [latest letter](#).)

Jamie Dimon’s job is to make money for his shareholders and even he has struggled – the bank’s stock price is only roughly where it was when Dimon took control in 2004. He really believes that the answer to his stock price doldrums is to make JP Morgan Chase bigger and more complex. In effect, he wants to load up on risk – hoping that this will pay off for him, his employees, and (presumably) his shareholders, and really not caring much about who bears the downside risk.

Lowenstein mentions at various points that Dimon was a protégé of Sandy Weill, but he neglects to remind us that Weill in his heyday espoused many of the same ideas that Dimon stresses in the interview. Weill believed there were great synergies between commercial and investment banking (and insurance). Weill was convinced that bigger was undoubtedly better both for shareholders and for society. He was wrong on all counts, as [explained by Katrina Brooker in the NYT earlier this year](#),

“The dream, the mirage has always been the global supermarket, but the reality is that it was a shopping mall,” says Chris Whalen, editor of The Institutional Risk Analyst, of Citi’s evolution over the last decade. “You can talk about synergies all day long. It never happened.”

Sandy Weill, of course, built the modern Citigroup, which effectively collapsed – in spectacular fashion – in 2008-09, and which had to be rescued by the government at least twice. What was Citigroup’s balance sheet at the time? It was just over \$2 trillion, roughly the size of JP Morgan Chase today. And Citigroup was (and is) extremely global – doing business in more than 100 countries.

Jamie Dimon is intent on building a bank that will surpass all the size and complexity records set by Sandy Weill’s Citigroup.

Whether or not JP Morgan Chase will fail on Jamie Dimon's watch remains to be seen. He is, without doubt, a relatively careful risk manager in an industry where hubris tends to run amok.

But sooner or later Jamie Dimon will hand over the reins to someone who is decidedly less careful, someone who goes with the groupthink, and perhaps even someone like Chuck Prince, head of Citigroup, who inherited Sandy Weill's mantle and said – in July 2007,

“When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing.”

The music had already stopped when he said that.

If the Dimon's bigger, more global, and greatly interconnected JP Morgan Chase is still dancing next time the music stops, the choice will not be bailout vs. great recession. The real choice will be no choice at all: fiscal disaster through attempted bailout (Ireland), or fiscal disaster through economic collapse (Iceland).

What Jamie Dimon Won't Tell You: His Big Bank Would Be Dangerously Leveraged

The Baseline Scenario » 2010 » December

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Simon Johnson

By [Anat Admati](#), Professor of Finance and Economics at Stanford Graduate School of Business. To see her explain these issues in person, watch [this Bloomberg interview](#). This is a long post, about 3,500 words.

The debate is raging about banks and their size, financial regulation, and the international capital standards known as “Basel”. Jamie Dimon of JP Morgan Chase, in his [New York Times magazine profile](#), expresses admiration for the Basel committee and says,

“... they are asking the questions that, in theory, bankers ask of themselves: how much capital do banks need to withstand the inevitable downturn, and what is an acceptable level of risk?”

There is one problem, however. Basel may have asked the right question, *but it did not come up with the right answers*, mainly because it allows banks to remain dangerously leveraged, setting equity requirements way too low. This fact is not understood because the debate on capital regulation has been mired with a cloud of confusion, and filled with un-substantiated assertions by bankers and others. As a result, the issues appear much more mysterious and complicated than they actually are.

After a massive and incredibly costly financial crisis, we seem to have financial system that is a more consolidated, more powerful, more profitable and, yes, *as fragile and dangerous* as we had before the crisis. How did this happen and what can we do?

Here are some questions on which the confusion is staggering.

(i) Is “too big” the same as “too big to fail?”

(ii) Do capital requirements force banks to “set capital aside for a rainy day” and not use it to help the economy grow?

(iii) Are banks different than non-banks in that high leverage is essential to banks’ ability to function?

(iv) Would terrible things happen if capital requirements were to increase dramatically?

The first order of business is to clear the fog and focus on the right things. I will try to explain. With the basics in place, answers will begin to emerge, or at least the right questions to ask.

By the way, I answer an emphatic NO to each of the above questions.

Let’s start with balance sheets

Take a bank; indeed take *any* firm. The *balance sheet* is a snapshot of assets and liabilities. It has two sides, often shown piled on top of one another in financial statements or online data.

On the left hand side, or the top, of the balance sheet are the firm’s *assets*, what the firm *owns*. The numbers come either in the oxymoron called “book value” that accountants produce based on historical costs, or in the more meaningful “market value,” which for illiquid assets might not be readily available, and which can change frequently. More typically, some assets appear at cost and some are “marked to market.”

On the right hand side, or the bottom, of a balance sheet are the liabilities and “shareholder equity,” a summary of the claims that are held by various parties “against” the assets. There are two basic types of claims here: one called broadly “debt” (or “liabilities”) and the other is “equity.”

There is a huge variety of debt claims. One that we all provide to banks is called “demand deposits.” Depositors can demand that this debt is paid back at any time. Other debt claims are distinguished by the length of the commitment, the interest rate, the collateral and the “seniority” (the place in the creditors’ queue in a bankruptcy) and other provisions. Depositors are the most senior creditors of a bank; junior, unsecured debt-holders, or holders of certain “hybrid” securities, are the last in this priority line. If a bankruptcy occurs, however, it can take years to sort all these different debt claims out.

One feature of corporate debt is that the tax code allows interest paid on debt to be called a business expense and it is deductible before corporate taxes are calculated. This is similar to the deductibility of mortgage interest payments for homeowners.

But the main feature of debt that distinguishes all debt claims from equity, is that debt is a *hard* claim, an “I Owe You.” Creditors have rights to take legal action if they are not paid what they are

owed. They can cause a financial *failure* or bankruptcy. This process can be a terrible thing or not so terrible. Airlines “fail” routinely and they renegotiate some contracts, re-organize, and emerge out of bankruptcy. No stigma is attached, and operations often continue, although of course it is bad news. And debt contracts work well when the bank finances individuals and businesses. Things are different, and much more problematic, when banks use a lot of debt to fund themselves. More on this later.

The final part of the balance sheet is the category of “equity.” Bankers like to call it “capital,” but let’s stick to the standard terminology of equity. (Using a different lingo than for other types of firms is part of the mystique of banking and helps in creating confusion.)

There are a few distinctions within equity too, mostly between “preferred” and “common” equity. Preferred equity, like debt, specifies how much the holder of the preferred will be paid. The lowest-class equity, called “common equity” cannot be paid at all until the preferred equity is paid what it was “promised.” The key difference with debt, however, is that the firm does not “fail” if it does not pay its equity holders, even if they are “preferred.”

Why does anyone buy this bottom-feeding equity? Because equity gets the upside, the profits of the firm, and if the firm is successful –and banks make a lot of money most of the time — this can be a very good deal. For banks, in fact, the return on equity is very high, often in the order of 25%. This is not something “abnormal.” It is likely the “appropriate” return, because this “leveraged” equity is also quite risky. In financial markets, the higher the risk, the higher the average or required return.

Leverage and funding costs: the basics

Financial leverage is about how much debt relative to equity a firm has. The more debt relative to equity, the higher is the leverage. Does it matter to overall funding costs how much debt vs equity a firm uses? There was a great deal of confusion about this way back in the first half of the 20th century. In 1958, two economists, Franco Modigliani and Merton Miller (who separately won Nobel prizes, partly for this work) considered this issue and showed that, while leverage does typically affect overall funding costs, *this is not due to the reasons people were giving at the time*, which were based mostly on the fact that equity has a higher required return than debt.

The so-called MM result from 1958 builds on a basic “conservation of value” principle. As leverage changes, so does the riskiness of equity (and sometimes that of debt as well), and thus its required return. If there were no *other* factors, such as third parties (think governments) taking or injecting cash in taxes or subsidies, *and* if the funding method did not affect the investment decisions of the firm that determine what is on the assets’ side of the balance sheet, then it would be irrelevant how much debt vs. equity is on the balance sheet. Of course, none of these “ifs” are true in reality, particularly for banks, so capital structure does matter, sometimes a lot.

MM is a basic “physical law,” taught in every basic corporate finance course, and the starting point of any intelligent discussion of financing decisions. Yet, quite astonishingly, bankers and others, with a straight face, routinely and to this date, make the outrageous claim that “Modigliani and

Miller does not apply to banks.” As if banking is so different from the rest of the world that it is exempt from natural laws. This is akin to saying that one can ignore the force of gravity because of air friction.

If there are frictions, we must consider their *impact*. Do air frictions work against gravity or in the same direction? Do frictions associated with funding favor debt or equity, in the sense that — in their presence — funding costs or the total value that can be created on both sides of the balance sheet favors a particular mix of funding means? And, importantly in the context of banks, because the funding decisions of any bank may have broader implications, if a bank chooses a certain way to fund itself, does it follow that society is best off under this structure?

Key observations on the effects of leverage

It turns out that the biggest friction in bank funding is not one that is “inherent” in the banking system or in funding more generally, something unavoidable and found “in nature,” like the wind. The main friction is the result of *government policies*. That would not be so bad if these policies worked to our collective benefits. Unfortunately, these policies go exactly in the wrong direction, favoring leverage that inflicts systemic fragility and extraordinary costs during crisis, precisely because they give bankers strong reasons to choose high leverage.

The fact is that, because of government policies, the funding costs of banks are lower the more debt they have relative to equity, i.e., the higher is their leverage.

Even worse, these same policies, and the resulting excessive leverage, distort the investment decisions of banks. They give incentives for excessive risk taking, which means that banks may overinvest in risky loans (something we witnessed quite clearly in the housing market leading up to the crisis). And it can interfere sometimes with banks’ ability to provide credit and fund valuable investments, because, with a lot of prior debt commitments hanging over them, it may be harder for highly leveraged firms to raise new funds. This so-called “debt overhang” problem contributed to the credit crunch that we experienced in the crisis.

Clearly, the consequences to society of highly leveraged banks are exceedingly negative. Yet, we have a system where we subsidize leverage!

If this sounds crazy to you, this is because it *is* crazy. The analog would be a government policy that subsidized pollutants, such that the more they pollute, the larger the subsidy. If pollution is bad for health and for the environment, and you required pollutants to limit emissions, they would obviously complain that their cost of production would increase, and this might be true because they lose subsidies. Does this mean we must subsidize pollution? Clearly not, especially if there is an alternative!

Continuing with the analogy, what if there was another process by which to produce the same product, which would actually not increase the cost of production but which is not chosen because of the subsidies given to the polluting technologies? This analogy is key to understanding the battle over bank funding. The way in which subsidies are given to banks makes no sense. If we believe that banks provide important services, and if we want to subsidize them, we must find other ways

to do so which do not lead to this perverse situation. We should not effectively *penalize* equity as a form of financing.

Leverage in banking and elsewhere

The tax code gives an advantage to debt financing not just for banks, of course. (Whether this makes sense is highly debatable. Many economists, including Michael Boskin, advocate abolishing the corporate tax code in part because of this effect.) But despite the tax incentives, many highly productive firms hardly use any debt at all, and no one chooses to fund themselves with anywhere near as much debt as banks. (The following, for example, are funded virtually only by equity: Apple, Google, Gap, Yahoo, eBay, Bed, Bath and Beyond, Broadcom, and Citrix.) This is because there are other forces that work against leverage, such as constraints lenders put on firms, and the distortions in investment decisions that are due to conflict of interest between equity and debt. An “all equity” firm is the gold standard for making good investment decisions, as it takes into account properly the upside and the downside of its decisions.

Everything is different for banks. Banks *love* high leverage. Whenever they make money, which is most of the time, they pay much of it out (to managers and shareholders), and they keep rolling over their huge debt, continuing to borrow more as they pay off what they owe. Equity is always a relatively small fraction of the total balance sheet. High leverage creates fragility because even a small change in the asset value can wipe out the equity and cause insolvency and financial “failure.”

Bankers tell us that they *must* be allowed to maintain high leverage because this is part of the business of banking. They assert that economies will suffer if they are made to fund more of their investments with equity, there will be credit crunches, terrible things will happen. We clearly must examine these statements carefully before agreeing.

Why banks choose high leverage, and why this has awful consequences

The “safety net” that was created to make sure banks’ operations are not disrupted by economic shocks, i.e., the fact that the FDIC, the Treasury, or the Fed, often stand ready and are expected to back up the banks’ liabilities, plays havoc on banks’ incentives to manage their risk and their leverage prudently and create a gap between what the banks find optimal and what is good for society. This is a very unhealthy situation.

The reason banks strongly prefer debt over equity is because their creditors or debt holders feel reasonably safe about being paid and thus do not require much in average return from the bank. Such creditors don’t have to put restrictions and conditions on banks’ activities. As long as they are confident they will be paid, creditors don’t care what the bank does with its money. When they become nervous, it’s often too late and the system freezes.

Why have we established this safety net for banks? Experience and research has shown that bank runs are very inefficient and disruptive. To prevent inefficient runs, deposit insurance was introduced. The safety net was expanded because the distress or failure of a bank has certain “contagion” effects and can thus be very disruptive and costly to the financial system and to the

economy.

Even the suspicion of possible insolvency for a bank can lead creditors to withhold further funding. Banks then may need to engage in massive “fire sale” of their assets to pay their debts, and even that might not be sufficient if they are truly insolvent. This can lead the entire system of credit and payment to freeze. Does this sound familiar?

Allowing the legal process of bank “failure” to work itself out is extraordinarily costly and disruptive, particularly for global banks subject to different legal systems. There are no great options here. The Lehman bankruptcy process, which is still going on for more than two years, has consumed many billions of dollars in direct and indirect costs. And we are still dealing with its fallout.

So when Jamie Dimon says that he favors resolution authorities and that JP Morgan “should file for bankruptcy” if the situation arises, we must ask ourselves the following: first, do we believe that the government will actually let JP Morgan go into bankruptcy, and if they did, would this be the right thing? Second, is there an alternative? Can we prevent more of these costly and disruptive failures and the need for bankruptcy and resolution procedures? And if so, how?

Is high leverage necessary for banks?

Here is the good news, and the simple and powerful answer. NO! Quite simply, *high leverage is not necessary for banks!* We *can* significantly lower the fragility and the likelihood of needing resolution and bankruptcy in banking by insisting that they use a lot more equity and less debt to fund themselves. And, for society, this will only have positive side effect, despite what the bankers say. Focusing on more equity funding is the simplest and most effective approach to the “too big to fail” problem, because it directly works to reduce the likelihood of “failure.” It does not rely on costly resolution or “bail-in” mechanisms that we are not sure would work or on bankruptcy courts. And it forces banks to “own up” to their investment decisions and alleviates many distortions associated with high leverage.

The business of banking does mean that banks cannot be funded completely with equity as Apple or Gap, because demand deposits and even money market funds and certificates of deposit are part of their business of financial intermediation. Thus, a certain amount of debt is built into banks’ balance sheet. But this does *not* imply that banks’ leverage must be as high as it is or as they would like it to be or even as high as Basel III would allow.

There is simply *nothing* that prevents banks from doing everything valuable for society at dramatically lower leverage, say 30% of total balance sheet. (In an interview [on CNBC in May](#), Gene Fama suggested 40% or 50% in equity for banks would be a good thing.) Some of the banks’ debt is not part of their business model and just serves to provide funding. And issuing more equity to support the liability on their own would not increase their funding cost *in a way that represents any social cost*. (If they lose some subsidies, we save on providing these subsidies!) .

Not only would we have a safer system if equity levels were dramatically higher, it is hard to think of any negatives, from society’s perspective, of doing so. Back to the pollution analogy, the alternative, clean technology of funding turns out to be cheaper than the polluting one once

subsidies are removed!

The fact that so much fog was created to prevent the above from being recognized by decision makers in Basel and in many governments, including US, is maddening.

There are other claims made in this debate, but the bottom line holds up upon closer examination: there does not seem to be any compelling reason that banks must be as highly leveraged as Basel III would allow. Those who say otherwise, and bank executives such as Vikram Pandit of Citi have complained that Basel III is too harsh on banks cannot justify their claims coherently. The only interpretation is that they are motivated by self interest.

In a paper I wrote with Stanford colleagues Peter DeMarzo and Paul Pfledierer and with Martin Hellwig from Bonn, we discuss in some detail every argument we are aware of regarding the mantra that “equity (or, as bankers call it, “capital”) is expensive.” We also discuss contingent capital and bailout funds, arguing that the equity-based solution dominates them. The [paper is available here](#).

Many experts agree with the conclusion of our paper, as is clear in this [letter signed by some very prominent academics](#) in finance and banking. For another letter I sent to *Financial Times* this week as part of this debate, see [this link](#).

Conclusion

The case for much more equity funding for large banks (and possibly other financial institutions) is overwhelming. The main challenges are to define the “regulatory umbrella” appropriately, to understand the “shadow banking” system, and to find effective ways to monitor the true risk and leverage of financial institutions on and off the balance sheets. These challenges can be met if energy is focused appropriately.

Sensible capital regulation does not necessarily involve a hard and fixed “number” for the equity ratio, but rather a flexible system of buffers and adjustments where the balance sheet of the banks is managed with the objective of allowing them to operate without overly endangering themselves and the system. Supervising the payouts and the funding methods of banks so as to keep the system healthy and functional is eminently possible if we take up the challenge.

First, however, we should remove the fog of confusion. Then we must find the political will to insist on prudent regulation before another crisis hits.

Comments on Hoenig, Dimon and banks being “too big”

Many argue that banks that are “too big to fail” are simply “too big.” In an excellent [op ed in the New York Times](#) this week, Kansas Fed president Thomas Hoenig identifies the key problems of “too big to fail” banks and argues that we should strive to create smaller banks, none too big to fail. Related proposals were made by Andy Haldane from the Bank of England (see [this link](#)), and by Simon Johnson and James Kwak, authors of the important book “[13 Bankers](#).” These proposals, and the so-called Volcker Rule, focus on the total size of the bank and more generally on the

“asset” side of the balance sheet. How does this relate to leverage?

If managed properly, breaking up the banks would likely be a step in the right direction. But we cannot ignore leverage. Many small but interconnected banks would still be fragile and subject to systemic risk and possible crises if each of them was highly leveraged. A small drop in the asset value of a leveraged bank leads to distress and possible insolvency, and this can be contagious in such a system. So fragility in the banking system invariably relates to the degree of leverage.

Jamie Dimon of JP Morgan says large banks are useful and efficient. He wants to be the Walmart of banking. Presumably, he wants to have the size of Walmart but he is not planning to have the type of *capital structure* that Walmart and firms like it have, with more than twice as much equity as debt on the balance sheet (at least by market value).

Mr. Dimon, how about you start helping the world of banking and the economy by pushing for banks to be much less leveraged, relying more on equity funding than Basel III allows, and for regulators to make sure they are? If you do that, your growth aspirations might seem a bit less scary.

Tax Cut Ironies

The Baseline Scenario » 2010 » December

12/6/10 at 10:43 PM

James Kwak

By James Kwak

From [The New York Times](#):

“Congressional Republicans in recent days have blocked efforts by Democrats to extend the jobless aid, saying they would insist on offsetting the \$56 billion cost with spending cuts elsewhere.”

Instead, as it turns out, they agreed to offset the cost with tax cuts elsewhere.

Still, though, I place the blame for this one squarely on the White House. The Republicans are just doing what Republicans do: arguing for lower government spending and lower taxes. The fact that they justify the former by saying it will cut the deficit and the latter by saying it will stimulate the economy (when you could just as easily switch the arguments and make them point the other way) is just a detail.

As I’ve [said before](#), the Bush tax cuts were always bad policy.* After the last election, President Obama will be able to accomplish precious little. But he could easily have killed the Bush tax cuts and thereby done more good for our nation’s fiscal situation than anyone will be in a position to do for many years to come. Killing the tax cuts would alone reduce the national debt by roughly as much as the deficit commission’s entire proposal. And killing the tax cuts was the path of least

resistance. Obama could have done it by *doing nothing*. Or he could have done it by taking a strong negotiating position and being willing to walk away from the table.

(Note to Barack: If you want to win a negotiation, you have to be willing to walk away. Take my daughter. If I threaten her with a three-minute timeout, she says, "I want a timeout for eight hours!" If I threaten to take away an episode of Dinosaur Train, she says, "I don't want to watch Dinosaur Train ever again!" You have two daughters, right?)

Instead, we got a two-year extension as part of an overall package that adds \$900 billion to the debt.

Now, [Ezra Klein](#), whom I agree with more often than not, says, "the White House and Congress are right to make the deficit less of a priority than economic recovery." Well, sure, in principle. But this deal isn't justified by that principle for two reasons. First, as [Paul Krugman](#) pointed out, a two-year extension will reduce the unemployment rate by 0.2 to 0.6 percentage points. Yes, that's hundreds of thousands of jobs, but it's at a cost of hundreds of billions of dollars. And at the current course and speed, those hundreds of billions of dollars will, in the long term, get taken away from the middle class in lower Social Security and Medicare benefits. The reason it's just 0.2-0.6 percent is that tax cuts, once again, are a lousy form of stimulus. According to Mark Zandi (via [Menzie Chinn](#)), the multiplier for the Bush income tax cuts is 0.29 and the multiplier for accelerated depreciation is 0.27.

Second, this can no longer be considered a two-year tax cut. This year, the Democrats gave in to the framing that letting the cuts expire would be a tax increase. President Obama has already nailed himself to the cross of "stop[ping] middle-class taxes from going up." With that on his resume, how is he going to flip-flop and let those taxes go up in 2012? He won't win a vote to cut taxes just for the middle class with fewer Democrats in Congress than he has now. So if he wants to preserve the middle-class tax cuts, he'll have to compromise again.

And Obama will no longer be able to say the tax cuts were a mistake made by President Bush that he was letting expire. Now he owns the mistake. This is a long way of saying that this isn't a two-year tax cut to stimulate the economy (with a 0.29 multiplier, remember) in a recession. It's a wedge of about 2 percent of GDP that is part of the structural deficit for the foreseeable future, just like the AMT patch that magically keeps getting extended.

Sure, they might not be extended in 2012. But I fail to see how the politics will be any different. "I protected you from a tax increase in 2010, but I'm raising your taxes now because . . . because . . . suddenly I care about the deficit . . . and we're not in a recession anymore." Yeah, right. By comparison, the message this time would have been easy: "I and the Democrats in Congress supported a bill to keep your taxes low. The Republicans blocked it because they insisted on tax cuts for the rich. Blame them." So the tax cuts might not be extended, but you could also say that Congress will vote to raise taxes. Not likely in either case.

So finally, you have to ask, what does Barack Obama want? Does he really like most of the Bush tax cuts? Does he really think the bulk of the tax cuts are good for the country, and that going along with the tax cuts in the top brackets is a reasonable price to pay to keep them?

* How bad? Here's one example. In order to pass the bill using reconciliation—the first time reconciliation was ever used to pass a [deficit-increasing bill](#)—they had to limit the ten-year cost of the bill. One way they did that was by adding a provision that allows upper-income taxpayers, in 2010, to convert their traditional IRAs to Roth IRAs. This is unambiguously good for upper-income taxpayers, because it's optional, so you can decide if you want to do it. So in the long term, it will result in lower tax revenues. But it artificially juices tax revenues in 2010, because when you convert you have to pay tax on the conversion amount now. That increased the amount by which they could cut taxes elsewhere in the bill. So, as my tax casebook puts it, the bill uses tax cuts for the rich to fund more tax cuts for the rich.

Should Megabanks Be Broken Apart? (NYT Room For Debate)

The Baseline Scenario » 2010 » December 12/7/10 at 10:36 PM Simon Johnson

By Simon Johnson. This material was prepared as part of the [New York Times' Room for Debate on "Should Mega-Banks Be Broken Apart"](#)? I strongly recommend the [post by Anat Admati](#).

Writing in the Washington Post, in November 2009, Jamie Dimon, chief executive of JP Morgan Chase, [argued](#):

“Creating the structures to allow for the orderly failure of a large financial institution starts with giving regulators the authority to facilitate failures when they occur. Under such a system, a failed bank's shareholders should lose their value; unsecured creditors should be at risk and, if necessary, wiped out. A regulator should be able to terminate management and boards and liquidate assets. Those who benefited from mismanaging risks or taking on inappropriate risk should feel the pain.”

But the Dodd-Frank financial reform legislation [does not create a “resolution mechanism”](#) that can deal with cross-border megabanks; this point is admitted by all involved. And there is nothing in the G20 process or underway with any other international forum that would make a difference in this regard.

So when very big banks are on the brink of failure, the Obama administration and Congress will have to face this choice: either let this big bank go through bankruptcy, like Lehman Brothers, or provide it with a bailout — meaning complete protection for all creditors (but hope you can at least remove some management this time around).

Unfortunately, the Irish experience shows that the “let's do an unsavory bailout” will like not end well next time. Our megabanks are getting bigger — as we demonstrated in [13 Bankers](#) and as [Thomas Hoenig](#) argued in the Times last week — not because of any kind of legitimate market process, but because they benefit from an unfair and non-transparent government subsidy. And these big banks have recklessly dangerous levels of debt relative to equity, as [Anat Admati and her](#)

[colleagues](#) have pointed out.

Put simply, by allowing our biggest banks to become even bigger — and more leveraged — the government is taking on a large contingent fiscal liability. Whatever you think of current fiscal policy — and whatever the outcome of the current debate over taxes and spending in the U.S. — remember this: by all standard balance sheet measures, Ireland was running responsible fiscal policy over the past decade. But the implicit liabilities of the Irish state were ballooning out of control, [in direct proportion to the size of the biggest Irish banks](#). Three banks failed and this has taken down the entire Irish economy.

There are no economies of scale or scope in banking over about \$100 billion in assets. Bankers, like Jamie Dimon, make claims to the contrary — including in [an interview](#) published in the New York Times on Sunday. But they do not have a single piece of evidence that society gains from having megabanks at today's scale and with today's leverage.

Our biggest banks are already subject to a partial size cap. According to the Riegle-Neal Act of 1994, no one bank can have more than 10 percent of total retail deposits in the United States. Unfortunately, the growth of wholesale financing and the global spread of these banks essentially made a mockery of this sensible macroprudential regulation.

We should update and apply the Riegle-Neal Act, exactly [as proposed](#) by Senators Sherrod Brown and Ted Kaufman in spring 2010.

If you would like to reproduce this entire post, please contact the New York Times.

More on the Tax Deal

The Baseline Scenario » 2010 » December 12/8/10 at 4:24 PM James Kwak

By James Kwak

First, the comic relief. From the [Times](#):

“Senator Jim DeMint, Republican of South Carolina, said that he still wanted the Bush-era rates extended permanently and that the cost of the package was worrisome.”

I got some valid criticisms for my [last post](#) on the tax cut deal. In particular, that post may make it seem as if my criticism of President Obama has to do with his negotiating ability. But if Obama really wanted the outcome he ended up with, then he is a master negotiator; where I really differ from him, then, would be in what policy should be.

Obama has said for years that he wants to preserve the tax cuts for the “middle class,” but not for the rich. For the purposes of this post, “middle class” means a household with less than \$250,000

in annual income. Of course, this is ridiculous, since \$250,000 lands you easily in the top five percent of the population by income, according to [Census figures](#). Why Obama chose to draw the line to separate the extremely rich from the very rich is something I've never understood. And besides, households above that line still benefit from the tax cuts as well, because they pay less taxes on their incomes up to \$250,000, just like everyone else. In dollar terms, someone making \$500,000 benefits just as much as someone making \$250,000, and much more than someone making \$50,000.

More recently, he has also said that he wants to stimulate the economy to help with the recovery. So you could say he got everything he wanted, except that he had to agree to tax cuts for the rich in order to get it.

Well, I want a pony. I want to repeal all the Bush tax cuts, and eliminate the mortgage interest deduction, and eliminate the income cap on payroll taxes, and eliminate preferential rates for dividends and capital gains, and tax carbon emissions, and cut the defense budget (and secure lasting peace in the Middle East). I want to use some of those increased revenues to reduce the long-term deficit, some to provide block aid to state and local governments, some to extend unemployment benefits permanently, and the rest to fund a refundable tax credit for poor people that will basically ensure a minimum standard of living for everyone. But that's not going to happen. You have to choose among the options you have.

In effect, saying that tax cut extensions for the rich are a reasonable price to pay to save tax cut extensions for the middle class is the same as saying that the Bush tax cuts were, on balance, a good policy. Or that securing one last extension of unemployment benefits (since they expire before the rest of the tax cuts, there's no chance they'll be extended again by a Republican-controlled House) was enough to make it good policy.

There is always the "in the middle of a recession" defense. But again, you don't get exactly what you want in politics. You can't say the deal was a good deal because you can fix all the bad things about it in two years. I also want stimulus now and higher tax revenues later. But *that's not a credible option*. If you think the tax cuts were bad policy, your chances of fixing that bad policy are much worse in two years than they are now. The administration's best card would have been a threat to veto any bill that contained an extension of the tax cuts for the rich. The House is going to pass an across-the-board permanent extension in 2012. Are the Democrats going to block it in the Senate in an election year? Is Obama going to veto it in 2012? (And even if he leaves it for a lame-duck session, he's going to have to make a commitment during the campaign.)

This was the best chance to kill the tax cuts once and for all. Yes, it would have been worse in the short run for the economy. But this is a huge price to pay for a modest stimulus made up entirely out of tax cuts (largely tax cuts for the rich). Instead, we are stuck with a huge reduction in the tax burden of the rich and a small reduction in the tax burden of the middle class—which, on balance, helps the rich and hurts the middle class—forever. If we can infer people's preferences from their behavior, then the logical inference is that Obama thinks the Bush tax cuts, taken as a whole, are good policy.

Finally, are the "middle-class" tax cuts really worth fighting for? Or, to put it another way, why does

Obama care about them so much? Contrary to the beliefs of the Tea Party, money doesn't just get eaten by a big monster when it goes to the IRS. It gets spent on stuff that ordinary people want and need. So a priori, we can't say that an additional dollar of tax revenue is good or bad for ordinary people.

Sure, the government is inefficient at spending money. But the question is, if we reduce "middle-class" taxes—remember, taxes on all households, affecting their income up to \$250,000 per year—does that help or hurt ordinary people? The extra dollars you have in your pocket have to be paid for somehow. They can be paid for by raising other taxes (not happening); by cutting non-entitlement spending, which is mainly the defense budget (not happening); by cutting entitlements, which provide net benefits to ordinary people because they are modestly redistributive (not happening); by printing money (not happening—the Fed is printing money, but not to fund the government deficit); or by doing nothing (happening).

Doing nothing, of course, is the old Republican "starve the beast" strategy: cut government revenues to the point where it is unable to do anything. In practice, Republicans have cut revenues and continued to spend on whatever they felt like spending on. But the core of the strategy is that if you cut taxes at every possible opportunity, eventually you will force the government into a crisis where something has to give (and probably it will be a Democratic administration that takes the political hit for cleaning up the mess). And unless American public opinion does an about-face, the thing that will give will be entitlements. (The only other logical possibility is our addiction to low taxes.)

So perhaps with the best intentions, the Obama administration, by making it more likely that the Bush tax cuts will become permanent (just like the AMT fix is permanent), is probably hastening the day when push will come to shove and Medicare will be gutted. The bigger the projected national debt, the more seemingly reasonable people in the middle of the ideological spectrum shake their heads sadly and say something has to be done about Medicare, as if it's a fact of nature and not a fact of politics. As I've said before, no administration has tried harder to control health care costs and thereby protect the future of Medicare. But at the same time, they are digging deeper the hole on the funding side that, politically, is the big threat to Medicare—and to retirement security for hundreds of millions of ordinary Americans.

Apparently Obama is upset at people on the left for insisting on purity. In his view of the world, he drew a line in the sand: he was going to protect tax cuts for the "middle class," and he succeeded. Maybe he did. Maybe we should be giving him credit for getting what he wanted. But if that's the case, he's drawing moderate-Republican lines in the sand. His priorities, as reflected in his policy decisions, are lower taxes (for everyone, not just the rich) and the smaller government that necessarily implies. And that's why the left is angry.

What Is Wrong With Cutting Taxes?

By Simon Johnson

The president and congressional Republicans have reached a deal that would cut taxes “for all Americans.” Their argument is that this package will stimulate the economy, create jobs and help lead to economic recovery and sustained growth.

This proposal, which seems likely to pass Congress, is not a good idea. Why? (To see me explain these points in a five-minute video, click [here](#).) Vice President [Dick Cheney](#) said, loud and clear, in 2002: “Reagan proved deficits don’t matter.”

He was right that [Ronald Reagan](#) showed the [Republican Party](#) that you can get away with running significant deficits as a result of tax cuts – exactly the strategy of President [George W. Bush](#).

But Mr. Cheney was completely wrong with regard to the implication that there are no economic consequences of sustained fiscal deficits.

I suggest you talk to the Greeks (now in the [International Monetary Fund](#)’s emergency ward) or the Portuguese (who are headed in that direction.) For that matter, listen to any policymaker in the [European Union](#) – they are all focused on bringing down deficits in a credible manner. And watch the European financial markets – people there are doubting and testing the fiscal credibility of all governments throughout the euro zone.

In fact, try persuading any responsible policy analyst anywhere in the world outside the United States that cutting taxes in the United States from current levels will boost growth so much that the cut will pay for itself” and end up reducing or at least controlling the fiscal deficit (the proposition of the [Laffer Curve](#)). You will be met great skepticism.

If the I.M.F. could speak truth to authority in the United States, it would tell you this most forcefully.

This does not mean that we should immediately move to cut our fiscal deficit – efforts to panic us in this regard are completely misplaced. Ironically, some of the fear-mongering emanates from the same part of the political spectrum as the vociferous demands for lower taxes; [there are no true fiscal conservatives](#) in America. Again, here, too, is a sharp contrast between the United States and anywhere else in the world.

But our “fiscal space” is limited – we cannot afford to blithely increase our national debt. It can be done – and should be done given the parlous state of our economy and our disastrously high unemployment levels. But it must be done carefully, so we get as much stimulative effect on jobs as possible for our debt-increase dollars.

Cutting taxes for the very rich is an ineffective way to stimulate the economy in the short term (for a detailed discussion, see [this post](#) by my colleague James Kwak). On this there is widespread agreement, including from the pages of The Wall Street Journal, where Robert Frank, a careful student of the rich and famous (and editor of The Journal’s Wealth Report and author of [“Richistan”](#)), said: “When I ask wealthy business owners and entrepreneurs why they’re not hiring,

they rarely mention taxes. They say consumer demand. And jobs.”

Three much more effective ways to support consumer demand and jobs would be:

Really extend unemployment benefits. There is nothing in the proposal on the table that will help people who have already been unemployed for 99 weeks – see [this explanation](#) from Nevada.

Don't lay off teachers anywhere in the country. The broader goal, of course, is to increase teacher quality, which is not easy and takes time (see the film “Waiting for Superman”). But firing teachers at any level of K-12 education makes no sense in the short or medium run.

Immediately hire more people to teach in community colleges. The unemployed – and those at risk of being fired – need new skills, particularly around information technology and the ability to run businesses. Give the long-term unemployed the opportunity and incentive to attend these classes. Help them get jobs – or start their own businesses. Even if those companies fail, the entrepreneurial experience will keep them in the labor force and enable them to enhance their skills – and become more productive employees when larger companies decide to start hiring in earnest again.

This post appeared on the NYT Economix blog this morning; it is used here with permission. If you would like to reproduce the entire post, please contact the New York Times.

Who Wanted What?

The Baseline Scenario » 2010 » December 12/10/10 at 6:24 PM James Kwak

By James Kwak

Look, I'm familiar with the argument for the tax cut deal. It's not a terrible argument. In simple form, it goes, the top priorities are to stimulate the economy and to cushion the impact of unemployment, and a two-year tax cut extension was worth it to get that, especially since we can kill the Bush tax cuts in 2012. Now, no one who wasn't born yesterday buys that bit about killing the Bush tax cuts in 2012, but you could still make the argument that two years of stimulus is worth making the tax cuts effectively permanent. (I don't agree, but it's not a crazy argument.)

But that's not Austan Goolsbee's argument on [YouTube](#).

Here's his slide:

Basically he's trying to convince you that Obama won: Republicans wanted the top-end tax cuts and Obama wanted the "middle-class" tax cuts, and Obama conceded the top-end tax cuts, but in exchange he won lots of other great things: unemployment insurance extension, some sweeteners to the earned income tax credit, American Opportunity tax credit (for college), some sweeteners to the child tax credit, lower payroll tax, and an extension of some business investment credits. Notice which column he put them in.

To call this framing disingenuous would be kind. Republicans also wanted the "middle-class" tax cuts; they were the Bush tax cuts, after all, and I don't recall any Republican saying we should only extend them for the very rich.

And if I try to imagine what it would be like to be a Republican, I'd have to say I probably like the extension of the investment tax credits (because they're for business, and they're LOWER TAXES); I probably like the American Opportunity credit (first because it's not very progressive—you have to be going to college in the first place, and it only phases out above \$160,000 for married filers—and second because it's LOWER TAXES); and I probably like the payroll tax cut (first because it's a tax cut that benefits everyone—the more you make, the more it benefits you, up to the cap—second because I like anything that hurts the funding for Social Security, and third because it's LOWER TAXES). I'm probably neutral on the child tax credit; I like subsidizing families, and it is LOWER TAXES, but this one might be a little bit progressive. And I'm probably against expanding the EITC (because it feels like welfare to me), and I'm definitely against extending unemployment benefits (because I think they're all deadbeats).

So I would reorganize this as follows:

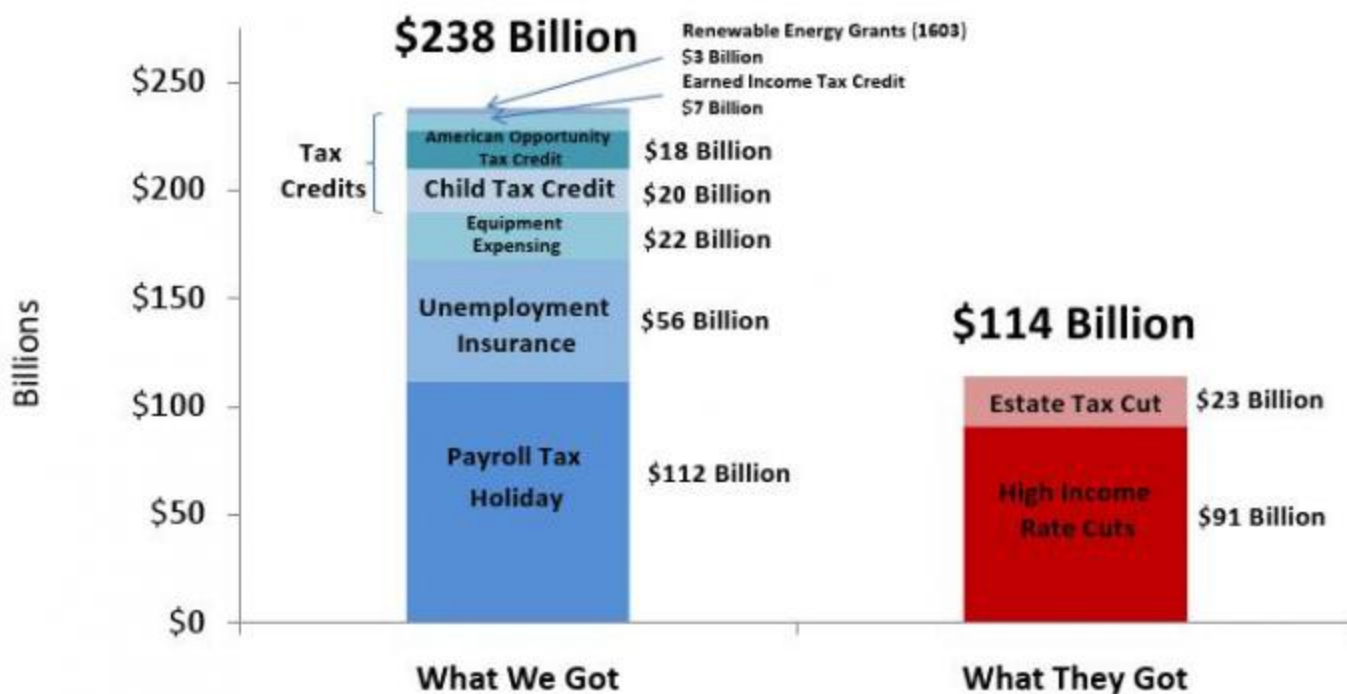
- Both sides wanted tax cuts for the lower 98%, the payroll tax cut, the investment tax credits,

and the American Opportunity credit.

- Obama wanted the EITC expansion, extended unemployment benefits, and the sweetened child tax credit.
- Republicans wanted tax cuts for the top 2%.

I'd say Republicans got a pretty good deal, especially since, as Goolsbee says, everything in the second bullet is temporary, while many observers are thinking today that the third bullet is forever.

I just noticed, thanks to [Ezra Klein](#), that Goolsbee's argument, minus the crazy claim that tax cuts for the lower 98% were not something Republicans wanted, is the core of the White House's marketing campaign:



To which I make the same response as to Goolsbee's video.

But let's leave aside this "who won" question. I admit I don't know what the Republicans want and don't want. But I wouldn't necessarily trust what they are saying, either. If you're John Boehner, you want to pretend you don't want things that you secretly want, so you can "concede" them in negotiations. And *anything* that lowers tax revenue is good for a fair number of Republicans. (In any case, this question turns largely on the question of whether or not Republicans are happy with the payroll tax cut. A lot of people have addressed that question already. Here's [Mike Konczal](#).) Finally, note that [Mitch McConnell has said](#) that the vast majority of Republicans will vote for the deal. That should tell you something.

There's a bigger issue. If you watch the video, the flow goes like this: "We wanted these tax cuts. The Republicans wanted these other tax cuts, and they were holding our tax cuts hostage. But we won, because not only did we get our tax cuts and they got theirs, but we got all these other tax

cuts!” Face it, the only thing on that board that isn’t a tax cut is extended unemployment benefits, although you can certainly make the argument that the EITC is more like a welfare program than a tax cut (and I’m certainly a fan of the EITC). The same goes for the chart.

So if you’re Grover Norquist and what you want more than anything else is lower tax revenue, you should be celebrating like it’s Christmas and your birthday at the same time. We had an argument where one side wanted tax cuts A, the other side wanted tax cuts B, and they compromised by adding tax cuts C? Here’s a great illustration from [Klein](#), who despite the chart is still in favor of the deal:

And the Democratic argument—trying to get support from the base—is “we got more tax cuts than they did”?

This American DREAM

The Baseline Scenario » 2010 » December 12/12/10 at 11:02 AM James Kwak

By James Kwak

[Brad DeLong](#) reminded me that the DREAM Act is being considered by Congress right now and has an outside chance of passage. If you are a Senator on the fence about this issue, or you work for one, you should listen to the last segment of this [This American Life episode](#), starting about forty-six minutes in. It will break your heart.

Oh, and given that opposition has been basically along party lines: aren't the people who would qualify for citizenship under the act natural Republican voters, anyway? Basically the act would reward people who pull themselves up by their bootstraps, without the benefit of federal aid. Or is that no longer what the Republican Party is about?

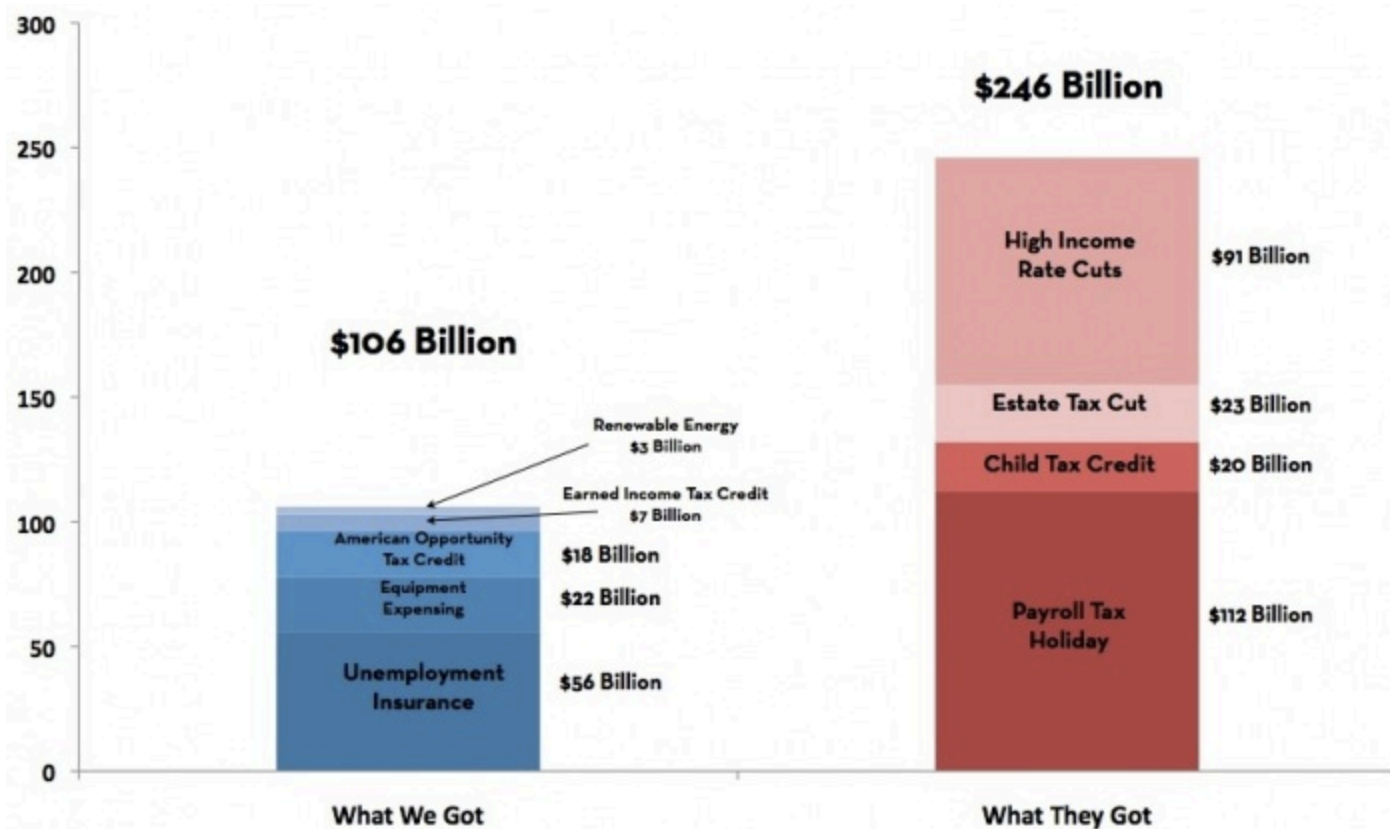
The Moderate Republican Stimulus

The Baseline Scenario » 2010 » December 12/13/10 at 1:57 PM James Kwak

By James Kwak

One of the great things about the Internet, as opposed to, say, law school, is that other smart people will do my homework for me. Last week I said that Obama's position on the tax cuts was a ["moderate-Republican line in the sand"](#) and that the tax deal was closer to the Republicans' ideal outcome than the Democrats', but the latter argument was based on some guesses about Republican preferences. Now [Mike Konczal](#) has done some of the harder argument, uncovering hard evidence that the Republicans would have agreed to the extended child tax credit sweetener anyway and presenting five points for the argument that the Republicans wanted payroll tax cuts – in particular, they wanted them more than Making Work Pay tax credit that they replaced.

Here's Mike's version of the administration's chart:



He calls it the “Moderate Republican Stimulus Package 2.0.”

13 Bankers in Paperback

The Baseline Scenario » 2010 » December 12/15/10 at 4:37 PM James Kwak

By James Kwak

Yes, that’s a new book photo in the sidebar to the right. The paperback edition will be available on January 11, 2011. It has a new epilogue taking the story from January 2010 (when we finished the hardcover) to September 2010, covering the financial reform debate in the Senate and the final Dodd-Frank Act.

Enjoy.

Republican Splits, Fiscal Opportunity

The Baseline Scenario » 2010 » December 12/16/10 at 5:54 AM Simon Johnson

By Simon Johnson

An informative and potentially productive political debate has broken out over fiscal policy. Ironically, this is not between Democrats and Republicans – the leadership on both sides of the aisle is trying hard to agree that [a moderate stimulus is worth increasing the national debt by nearly \\$900 billion](#). And the new debate is not particularly due to the Bowles-Simpson bipartisan commission or other serious efforts to put the real math on the table; those technical discussions have so far been brushed aside.

Rather the intensifying and illuminating debate is [within the Republican Party](#) – particularly between people who are reasonably presumed interested in running for the presidency in 2012.

On the one hand, there are those such as Newt Gingrich and Mike Huckabee, who are in favor of the tax deal currently on the table. This seems to be where most of the Republican mainstream is. On the other hand, Sarah Palin and Mitt Romney have come out strongly against the proposal.

On the merits of the economic argument – within the terms of reference laid down by Republicans themselves – Romney and Palin have the advantage. The House Republican Pledge to America, after all, said [clearly and forcefully](#), “We will put government on a path to a balanced budget and pay down the debt.” This is hardly where the latest fiscal stimulus is leading, including with pork barrel measures that the Republicans just spent months saying they would never pass.

Of course, this really this is all about politics. Romney and Palin are betting that unemployment will still be over 9 percent in 2012 (at least during the primaries) and anyone who supports any kind of stimulus now can be represented as a partial owner of that continuing human recession. Gingrich and Huckabee are betting that a broader economic recovery will be underway, so they can say: the 2009 Democratic stimulus didn’t work, but the 2011 Republican-led tax cut package made all the difference.

Who is making the right judgment? The Barney Frank Principle will be in effect – Frank is famous for emphasizing that voters never judge politicians relative to some hypothetical, but rather on the basis of how badly they dislike the actual outcome.

Still there is a big opportunity lurking here for the Democrats. The president owns the recession and its aftermath, whether or not you (or he) think that is fair. The tax deal with the Republicans may bring on board some unlikely co-owners, but it doesn’t much diminish Mr. Obama’s vulnerability in the general election.

But the White House can still get ahead of events by setting up a Tax Commission, to be directed by Alice Rivlin. This should not be another attempt to build bipartisan consensus – as we can see from recent events, there is no way this would lead in a responsible direction. Rather Rivlin, a former Congressional Budget Office director who is immensely sensible and respected across the political spectrum, should be empowered to come up with sweeping tax code changes that would reduce rates, lower complexity, and – here’s the point – raise revenue.

The economic opportunity here is that the US tax code is a complete mess. Sensible reform would reduce distortions while also increasing revenues. Rivlin has already made some [reasonable](#)

[proposals in this direction](#), but she needs the political authority to go further.

The weakness in the Palin-Gingrich position is that while they want to balance the budget, they want to do so primarily by cutting spending. This is very difficult to do, as most of the spending issues over the next 30 years are about Social Security (a little) and Medicare (a lot); see [this primer](#).

Cutting or limiting nonmilitary discretionary spending may play well with voters but it is simply not big enough to make that much difference. If Palin and Gingrich are willing to put military spending on the table, that would help, but this is fast becoming a taboo subject for all Republicans.

Most of all, the Republican side of the aisle is against increasing federal government revenue (as a percent of GDP) under any circumstances. This is not a strong position because how much revenue you want to raise should depend on what it costs (due to the distorting effects of taxes) and how you will use it – for example, as more people retire, do you really want to cut average pensions in real terms?

The Rivlin Commission would at least be insurance against the downside scenario – that we face a serious fiscal crisis, with sharply rising interest rates, at some point in late 2011 or early 2012. This could very well happen as the eurozone is likely to sort out its problems – serious but not insuperable – over this time frame. Our underlying fiscal position is no stronger than European countries now under pressure and our ability to make effective fiscal adjustments under pressure is just as likely to be tested (and initially found wanting) by financial markets.

Both Republican factions might not worry too much about a perceived fiscal crisis in the run-up to 2012. This would let them play to their themes of “we must cut spending,” and a major lesson from the current eurozone debacle is that crises do lead to big spending cuts – whether or not those make sense from a longer term productivity and fairness point of view. (In this regard, consider Congressman Brad Miller’s [important points on Social Security](#).)

Rivlin-type proposals would give the president a powerful counterweapon. Instead of “just cut spending” as the response to rising long-term interest rates, he could present a menu of sensible comprehensive tax reform steps. Then the 2012 presidential campaign could, in part, be about the extent to which people would like to (a) cut Social Security, or (b) reform the tax code.

And, hopefully, if we are really having an adult conversation at that time, let’s hope that both sides agree on the need to control future increases in healthcare costs – as reflected in Medicare and Medicaid, but also more broadly. Without that, [we are bankrupt in any case](#).

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

By Simon Johnson

If you honestly believe that investors will happily buy up any amount of US government debt (at low interest rates) for the indefinite future, then relax. The [tax deal passed yesterday](#) should make you happy.

But if you fear that the US will soon be tested by financial markets – just as the eurozone is being tested today – then please read my column, "[Voodoo Economics Revisited](#)", which is now on the Project Syndicate website. There is a well-established tradition in the Republican Party of thinking that tax cuts cure all ills; many in the Democratic leadership have apparently now fallen into line. We need to think hard about what our fiscal crisis will look like – and who will end up being hurt the most.

Another link to the column: <http://www.project-syndicate.org/commentary/johnson15/English>

"Washington and the Regulators Are There To Serve the Banks"

By James Kwak

It is too obvious to bear saying, but I'll say it anyway.

At the urging of the administration, Congress passed a financial reform bill this past summer that expanded the theoretical powers of regulators, but also gave those regulators the power to write the rules implementing the bill and then to enforce the rules. The bill's sponsors fended off efforts to write specific constraints, whether size limits or leverage limits, into the statute. Yet the bill did nothing that I am aware of to ensure that regulators do a better job than they did last time around, unless you count the creation of a standalone consumer protection agency. (Yes, this is a hard problem with no easy solutions, but ignoring it doesn't make it go away.)

Now we will see the results. Via [Mark Thoma](#), [Andrew Leonard](#) provides the money quote, from incoming House Financial Services Committee chair Spencer Bachus: "in Washington, the view is that the banks are to be regulated, and my view is that Washington and the regulators are there to serve the banks."

Of course, having written a book that argued that politics is more important than economics, this doesn't surprise me. Nor does the decision by the Financial Crisis Inquiry Commission's Republican appointees to [deny that the shadow banking system even exists](#), or to write a dissenting "primer"

whose only possible motivation can be captured in Barry Ritholtz's post, "[Repeat a Lie Enough Times . . .](#)" But what frustrated me about the administration's position over the spring and summer was the idea that, despite this basic fact, they marched forward as if government regulation is a purely technocratic problem that can be solved by simply finding smart men and women of integrity and conscientiousness.

The Obama Renaissance

The Baseline Scenario » 2010 » December 12/17/10 at 12:52 PM James Kwak

By James Kwak

President Obama is enjoying something of a political resurgence, at least among the commentariat. [Ezra Klein](#) points out that his approval ratings remain higher than those of his Congressional opposition, as opposed to Clinton in 1994 and Bush in 2006. In The New York Times, [Michael Shear](#) says the lame-duck session of Congress could be a "big win" for Obama, and [Matt Bai](#) hails the tax cut compromise as "responsible governance" and says it could lead to a successful presidency.

Obama is certainly in a decent position politically, and I would bet on him to be reelected comfortably in 2012. First off, his opponents in Congress are deeply irresponsible (admittedly: "[The single most important thing we want to achieve is for President Obama to be a one-term president.](#)") and face a huge political problem within their own party: a significant portion of the conservative base really does want lower deficits, yet the only thing the Republican caucus knows how to do is cut taxes. [Klein](#) points out that the Republicans will eliminate House rules that spending increases or tax cuts have to be offset elsewhere, and will instead say that "tax cuts don't have to be paid for, and spending increases can't be offset by tax increases." Second, the Tea Party and Sarah Palin mean that Obama is likely to face an opponent who has been pulled dangerously close to the lunatic fringe during the primary (or, even better yet, Palin herself). And third, there's triangulation.

Bai basically parrots the Obama administration's line: they did the tax cut deal because it was good policy, it would stimulate the economy, and they got a good deal. In other words, it's not a cynical political tactic, it's good governance. And as [I've said before](#), I think the Obama team may actually believe that, because their idea of good policy was centrist to begin with.

Did you notice that their key talking point on the tax cut issue was about not raising middle-class taxes in the middle of a recession? Well, this conveniently overlooks one key fact: they wanted to preserve the Bush tax cuts regardless of economic conditions. Even I forgot (until [Klein reminded me](#) in a post on something completely different) that the administration wanted to make the middle-class tax cuts permanent. Remember, these "middle-class" tax cuts go up to \$250,000—around the 98th income percentile. And for true ordinary American households, they are negligible, because those households don't pay much income tax; as of 2009, according to the [Tax Policy Center](#),

middle-quintile households have an average income tax rate of 2.3 percent. (They pay much more in payroll taxes.) So even Obama's preferred policy — killing the tax cuts on the super-rich (over \$250,000) and keeping them for the upper-middle class and the moderately rich — is a regressive policy: it lowers the tax burden on people making more than average, thereby forcing the government to cut services that benefit everyone.* And it increases the pressure to cut Social Security and Medicare, which do benefit ordinary people.

So no, I don't think Obama is abandoning his principles for political advantage; I think these are his principles. And while I'm upset at him, I'm upset at him for being wrong on the policy level, not for abandoning anything or selling out. I think a lot of the bitterness on the left comes from people who thought he was more progressive than he is, and now feel betrayed. As I [said in January](#), I always thought Obama was a moderate who looked like a progressive (certainly the most moderate of the three main 2008 primary candidates), and, as Nate Silver said, "what Obama has wound up with is an unpopular, liberal sheen on a relatively centrist agenda." What's happening now, if his good run continues, is he is shedding the liberal sheen and getting a centrist sheen on a centrist agenda. And politically, that's all good for him. Combine that with his obvious political skills, and the future looks bright for him.

* I know that the administration also supported extending other tax cuts and credits that are more progressive, but those were mainly intended to be temporary, such as the tax cuts in the 2009 stimulus bill.

Why Citigroup?

The Baseline Scenario » 2010 » December

12/18/10 at 8:00 AM

James Kwak

By James Kwak

I think [Ezra Klein](#) is probably right about Peter Orszag:

"Citigroup is a really big, really powerful institution. Orszag's position in it is the sort of position that could one day lead to being president of Citigroup. If you're him, and you're trying to figure out an interesting and high-impact way to spend the next 40 years, I can see why it's appealing. But it's the power and the job and the opportunity, more than the money, that make it appealing."

Klein says the problem is that this kind of job transition makes people lose faith in government, and I agree with that. But I think there's a deeper problem as well.

This is the mindset of the ambitious educational elite: You go to Harvard (or Stanford), maybe to Oxford (or Cambridge) for a Rhodes (or Marshall), then to Goldman (or McKinsey, or TFA), then to Harvard Business School (or Yale Law School), then back to Goldman (or Google), and on and on. You keep doing the thing that is more prestigious, opens more doors, has more (supposed) impact

on the world, and eventually will make you more and more famous and powerful. Money is something that happens along the way, but it's not your primary motivation. Then you get to Peter Orszag's position, where you can do anything, and you *want* to go work for Citigroup? Why do our society and culture shape high-achieving people so they want to be executives at big, big companies that are decades past their prime? Why is that the thing people aspire to? Orszag wanting to work at a megabank — instead of starting a new company, or joining a foundation, or joining an NGO, or becoming an executive at a struggling manufacturing company that makes things, or even being a consultant to countries with sovereign debt problems — is the same as an engineer from a top school going to Goldman instead of a real company. It's not his fault, but it's a symptom of something that's bad for our country.

Symbols and Substance

The Baseline Scenario » 2010 » December

12/19/10 at 9:35 PM

James Kwak

By James Kwak

Arnold Kling wins the prize for the [most erudite post](#) of the past week, a review of *The Symbolic Uses of Politics*, by Murray Edelman. Kling cites not only Sigmund Freud and J.D. Salinger, but Theodor Adorno and Seymour Lipset (with specific books, not just names), among others.

In Kling's summary, Edelman divided the political sphere into insiders and outsiders (Kling's terms). Insiders are basically special interests: small in number but well organized and with specific goals. Outsiders, or the "unorganized masses," are the rest of us: we have some interests, but we are poorly organized to pursue them and therefore are generally unsuccessful. In particular, Outsiders suffer from poor and limited information, and therefore are especially susceptible to political symbols. In Kling's words:

"Given these differences, the Insiders use overt political dramas as symbols that placate the masses while using covert political activity to plunder them. What we would now call rent-seeking succeeds because Outsiders are dazzled by the symbols while Insiders grab the substance."

This seems like a pretty straightforward description of why interest groups are politically powerful. I think Edelman's additional contribution is the emphasis on the use of symbols by the Insiders to distract the Outsiders: "For Edelman, symbolic reassurance and political quiescence were somewhat troubling phenomena. The masses were being lulled by symbolic gestures into accepting adverse political outcomes."

In any case, Kling thinks that Simon and I are too positive about Elizabeth Warren — not because Warren is a bad person, but because, in his words, "expect the banks to be able to do a more efficient job of rent extraction with Elizabeth Warren in place than before."

One the one hand, this is a valid point. I'm pretty sure that Kling and I agree that a major problem with our financial system has been the ability of entrenched incumbents to use government policy as a rent-extraction device; think, for example, of the banks lobbying the OCC and the OTS to preempt anti-predatory lending laws in the early 2000s. Since we live in a democracy, the ability of elites to use the government to their advantage requires our political institutions to have some minimum level of credibility. If everyone believed that government was simply a tool for the rich and powerful, the entire system would break down and would have to be maintained by force, if at all. (This is like my argument that a facially progressive yet riddled-with-regressive-exceptions tax code is [just what rich people want](#) — were it not facially progressive, it would have legitimacy problems.)

Seen from this angle, then, the Insiders want to lose some battles. If they were to win all of them, the Outsiders would get suspicious. So what the Insiders really want is to lose the symbolic battles and to win the substantive battles. And I guess Kling is arguing that the appointment of Elizabeth Warren is a symbolic battle, not a substantive one.

On the other hand, though, does that mean that I should be *opposing* the appointment of Elizabeth Warren? I don't think Kling would go that far. Probably he would simply say that I am overestimating her potential impact in the grand battle with the Insiders of the financial sector. I agree that one should not overestimate the impact of one person or one agency, and I also suspect that some people in the administration were happy to go along with the Consumer Financial Protection Bureau because it gave them disproportionate political cover for a bill that, in many ways, and perhaps more important ways, is too soft on Wall Street.

But I don't think I'm naive on this point. My big worry is what will happen to the CFPB when the next Republican president comes into office, and I don't have a good answer for that — because I don't think we've yet come up with a great answer to the problem of regulatory incentives. And in any case, Warren does have some power, and she will use it, and that will make some difference. An agency with the words “consumer protection” in its name will have a harder time screwing ordinary people than an agency with the words “comptroller of the currency” or “federal reserve” in it, although future directors will no doubt try. And an agency is a big, complicated organization, which means it will have a culture, and it will have inertia. So who starts up an agency can matter.

On balance, I still think the CFPB and Elizabeth Warren are good for the middle class, for poor people, and for America. I don't think we can just call it a clever chess move by our Insider overlords. That leads to a view of the world that can too easily always explain everything.

And besides, isn't all this “symbolic reassurance and political quiescence” stuff more applicable to the Tea Party, which is itself a big-budget re-run of *What's the Matter with Kansas?* Or “is this time different”?

Bankers' Pay On The Line Again

By Simon Johnson

The people who run big banks in the US have had a good year. They pushed back hard on financial reform legislation during the spring and were able to defeat the most serious efforts to constrain their power. They and their non-US colleagues scored an even bigger win at Basel this fall, where the international committee that sets financial safety standards decided to keep the required levels of equity in banks at dangerously low levels. And the counter narrative for the 2008 financial crisis, "[Fannie Mae made me do it](#)," gained some high profile Republican adherents closely aligned with the men who will control the House Financial Services Committee in 2011-12.

But there is also a potential lump of coal in Santa's sack for the biggest banks, in the form of restrictions of pay – both its structure and perhaps even the amounts (although officially the latter is not currently on the table).

The impetus here comes not from American "populists" of any kind – although reformers of left and right have been pushing for progress on this issue since massive bonuses were paid out by firms that were saved by the taxpayer in fall 2008 (and again in 2009 in some cases). [According to the Wall Street Journal](#), for 2008 there were nearly 5,000 bonus payments in excess of \$1 million at "the largest US banks that accepted Treasury aid."

Rather the push to constrain bank executive pay comes from officials and the political elite in continental Europe – supported by an increasingly effective pro-reform group around the Bank of England (led by Mervyn King, the governor). There is also supportive language in the Dodd-Frank financial reform bill, although this by itself rather vague and completely open to interpretation by the regulators.

Still, the overall proposal is entirely reasonable and well thought through at a general level: "lock-up" a considerable fraction of bank bonuses until we see, after several years, exactly how the banks do.

The issue, of course, is that banks (with their ludicrously low levels of equity; if this point is not clear to you, [see this primer](#)) can juice their returns considerably by taking on more risk. These risks may not be apparent for quite a few years – depending on how long it takes the credit cycle to run its course. Eventually, if those risks threaten to bring down one or more big banks, there may be a rescue by the taxpayer – and there is nothing fair or politically palatable about that.

Bank executives hate the idea that their pay will be constrained in any way. In Europe, where bankers are less powerful than in the US, they have already lost this battle – although there is still a lot of fighting about details and implementation to be done.

In the US, as we head into 2011, expect to see three types of pushback from the banks' very sophisticated PR machines.

a) "We already ended Too Big To Fail". But we didn't, at least for the global megabucks that would be subject to these compensation restrictions. There is no way to handle the failure of a cross-

border systemic bank, although than through Lehman-like collapse. The case for stronger preemptive action to reduce system risk is overwhelming.

b) “This would weaken us relative to our global competitors”. Not really – given that it is the regulators of our main competitors who are initiating this move. To be sure, Chinese banks are not likely to follow suit, but that is hardly relevant – and since when do we let China dictate our regulations or supervisory practices?

c) “This represents an inappropriate extension of government into private business decisions”. But there is little new here – at least since the 1930s, the relevant authorities have had the power to limit dangerous-risk taking by systemically important banks; the intent of the Dodd-Frank financial reform act was definitely to update and strengthen those powers. Banks are different from other businesses; their failure can jeopardize the entire economy – as we saw in 2008-09.

The banks will also worry that such pay restrictions will encourage their top talent to leave and join the relatively unregulated hedge fund and private equity sector. This is a legitimate point – and suggests that the pay reforms may actually be implemented. When powerful people (the hedge funds) want a change because it will disadvantage their competitors (the big banks), such changes are much more likely to happen in the American financial system.

Pushing risk-taking into hedge funds or other relatively unregulated entities does not of course solve the deeper problems that brought us to the brink of disaster in fall 2008. But attempts to develop a more comprehensive approach for the system – limiting size and leverage (debt relative to equity) for the biggest players – were defeated at the behest of the big banks.

Pay restrictions are not the ideal solution and they are not the end of the reform story. But we should take what we can get at this stage. Or, as seems more likely, we should encourage this debate to move into a more public arena – perhaps the regulators will push for restrictions and House Financial Services will raise objections.

The fight to make our financial system safer has barely begun.

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

Tax Cutters Set Up Tomorrow's Fiscal Crisis

The Baseline Scenario » 2010 » December 12/28/10 at 10:02 AM Simon Johnson

By Simon Johnson. This post slightly updates the first few paragraphs of my most recent column on Bloomberg, which ran last week. For the rest of that column, [use this link](#).

President [Barack Obama](#) is receiving congratulations for moving to the center on the tax agreement with Republicans.

Both sides think they got something: Democrats feel this will nudge [unemployment](#) below 8.5 percent in 2012, helping the president get reelected; Republicans achieved longstanding goals on measures such as the estate tax and think they will get most of the credit for an economic recovery that's already under way.

The truth is, the deal moved us closer to a fiscal crisis, just as the euro zone now is experiencing.

Who will emerge on top in the U.S. version is harder to predict; at the moment, Republicans have the edge. But it's not clear even they will be happy with what they wished for — an opportunity to enact massive federal government spending cuts.

To read the rest of this column, [please click here](#). Alternatively, you can use the full address: <http://www.bloomberg.com/news/2010-12-23/tax-cutters-set-up-tomorrow-s-fiscal-crisis-commentary-by-simon-johnson.html>

Why Can't Europe Avoid Another Crisis? Why Can't the U.S.?

The Baseline Scenario » 2010 » December

12/30/10 at 7:40 AM

Simon Johnson

By Simon Johnson

Most experienced watchers of the eurozone are expecting another serious crisis to break out in early 2011. This projected crisis is tied to the rollover funding needs of weaker eurozone governments, i.e., debts falling due in March through May, and therefore seems much more predictable than what happened to Greece or Ireland in 2010. The investment bankers who fell over themselves to lend to these countries on the way up, now lead the way in talking up the prospects for a serious crisis.

This crisis is not more preventable for being predictable because its resolution will involve politically costly steps – which, given how Europe works, can only be taken under duress. And don't smile as you read this, because this same logic points directly to a deep and morally disturbing crisis heading directly at the United States.

The eurozone needs to – and will eventually – take three steps:

1. Agree on greater fiscal integration for a core set of countries. This will not be full fiscal union, but it will comprise some greater sharing of responsibilities for each other's debts. There is much room for ambiguity in government accounting and great guile at the top of the European political elite, so do not expect something completely clear to emerge. But Germany will end up underwriting more of the liabilities for the European core – the opposition Social Democratic Party and the Greens are

very much pushing Chancellor Angela Merkel in this direction by calling her “unEuropean”.

2. For the core countries, the European central bank (ECB) will receive greater authority to buy up government bonds as needed. Speculators in these securities will be badly burned as necessary. The wild card here is whether Bundesbank president Axel Weber will get to take over the ECB in fall 2011 – as expected and as apparently required by Ms. Merkel. Mr. Weber has been vociferously opposed to exactly this bond-buying course of action. The immovable Weber will meet the unstoppable logic of economic events. Good luck, Mr. Weber.

3. One or more weaker countries will drop out of the eurozone, probably becoming rather like Montenegro – which uses the euro as its currency but does not have access to the ECB-run credit system. Greece is probably the flashpoint; when it misses a payment on government debt, why should the ECB continue to accept Greek banks’ bonds, backed at that point effectively by a sovereign entity in default? The maelstrom will probably sweep aside Portugal and perhaps even Ireland; the chaos will threaten Spain and Italy.

It would be so easy to set up preemptive programs with the IMF for Portugal and Spain, but this will not happen. The political stigma attached to borrowing from the IMF is just too great.

The unfortunate truth is that despite its much vaunted supposed return to preeminence and the renewed swagger of senior officials, the IMF remains weak and of limited value. It is an effective lender to small European countries under intense pressure – Latvia, Iceland, Greece, etc. But the Fund does not have the resources or the legitimacy to save the bigger countries.

At the end of the day, the Europeans will save themselves, with the measures outlined above – only because there will be no other way to avoid wasting 60 years of political unification. But this action won’t “save” everyone; one or more countries will be forced out of full eurozone membership (although they will likely keep the euro as the means of exchange). And the costs to everyone involved will be large and largely unnecessary.

And remember, when the financial markets are done with Europe, they will come to test our fiscal resolve. All the indications so far are that [our politicians will also struggle to get ahead of financial market pressure.](#)

There are plenty of places in Europe where you can find an easy political consensus is to cut taxes and increase budget deficits. Sadly, this no longer pacifies markets. The American political elite – right and left – believes that we are different from the Europeans because we issue the dollar and therefore have some special privileges for ever.

But this is not the 1950s. Asia has risen. Europe will sort itself out and become more fiscally Germanic. The Age of American Predominance is over.

Our leading bankers looted the state, plunged the world into deep recession, and cost us 8 million jobs. And now many of them stand by with sharpened knives and enhanced bonuses – also most willing to suggest how the salaries and jobs of others can be further cut. Think about the morality of that one.

Will no one think hard about what this means for our budget and our political system until it is too late?

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The More Things Change ...

The Baseline Scenario » 2010 » December 12/31/10 at 10:23 PM James Kwak

By James Kwak

As a holiday gift to myself, I've actually been reading a real book, on paper — *The Worldly Philosophers*, by Robert Heilbroner. The book itself was not a gift to myself; I have my sister's old copy, which is the 1980 edition. The book is a traditional intellectual history of some of the main figures in economics. As the original was written in 1953, it focuses less on the mathematical line of economics, from Walras and Marshall through Arrow-Debreu to the present, and more on what used to be called political economy: Smith, Ricardo, Mill, Marx, Keynes, etc. It's not a way to learn economics, but a way to learn something about the historical conditions that helped give rise to some important economic ideas.

But some passages seem oddly relevant today. Discussing the conventional economic wisdom of the early nineteenth century (pp. 121-22):

“They lived in a world that was not only harsh and cruel but that rationalized its cruelty under the guise of economic law. . . . It was the world that was cruel, not the people in it. For the world was run by economic laws, and economic laws were nothing with which one could or should trifle; they were simply *there*, and to rail about whatever injustices might be tossed up as an unfortunate consequence of their working was as foolish as to lament the ebb and flow of the tides.”

And on the conventional economic wisdom of the late nineteenth-century Gilded Age (p. 215):

“Indeed, the world was so scrubbed as to be unrecognizable. One might read such leading texts as John Bates Clark's *Distribution of Wealth* and never know that American was a land of millionaires; one might peruse F.H. Taussig's *Economics* and never come across a rigged stock market. If one looked into Professor Laughlin's articles in the *Atlantic Monthly* he would learn that ‘sacrifice, exertion, and skill’ were responsible for the great fortunes.”

The hero of that chapter is Thorstein Veblen, who argued that the so-called captains of industry were not the sources of technological progress and economic development, but a parasitic class

engaged in financial games to divert excessive profits to themselves: “The bold game of financial chicanery certainly served as much to disturb the flow of goods as to promote it” (p. 235). For Heilbroner, writing and rewriting during the thirty years of postwar prosperity, this was a problem of the past; Veblen did not see the ability of capitalism to evolve into a more efficient, more socially beneficial form.

For us, however, that progress seems less certain, and the financial engineering of the past decade seems little removed from the exploits of the nineteenth-century robber barons. And conventional economic wisdom — not the stuff taught in Ph.D. programs, but the thin veneer of economism that dominates public discourse (raise the minimum wage and unemployment will go up; increase regulations on banks and capital will contract and unemployment will go up; increase the estate tax and business owners will work less hard and unemployment will go up) — has hardly changed, either.