

*By James Kwak*

In October, [Gerald Epstein and Jessica Carrick-Hagenbarth](#) released a paper documenting potential conflicts of interests among academic economists writing about the financial crisis and financial reform. Focusing on the Squam Lake Working Group on Financial Regulation and the Pew Economic Policy Group Financial Reform Project, they found that a majority of the economists involved had affiliations with private financial institutions, yet few of them disclosed those affiliations even in academic publications (where they do not face the word constraints imposed by print newspaper editors), preferring to identify themselves by their universities and as members of prestigious institutions such as NBER. To be fair, they did *not* find a strong relationship between economists' affiliations and their positions on financial reform, perhaps because of the small sample and the limited amount of variation in the positions of members of these groups.

Epstein and Carrick-Hagenbarth called in their paper for economists to disclose any potential conflicts of interest, especially when writing for a general audience. This proposal has picked up some steam, first in the blogs ([me](#); [Nancy Folbre in Economix](#); [Felix Salmon \("it's not going to happen: there's too much money riding on the continuation of the status quo"\)](#); [Mark Thoma](#); [Mike Konczal](#); [Planet Money](#)) and, more recently, thanks in part to the movie Inside Job, in the mainstream press. According to Sewell Chan in [The New York Times](#), the AEA claims that it will consider a new ethical code or at least disclosure rules for economists – although, in a forthcoming book, “[George] DeMartino describes concerns dating to the 1920s about the influence of business on economic research, and cites multiple calls within the association for a code of conduct — all of which have been rebuffed.”

Epstein and Carrick-Hagenbarth have drafted a letter to the president of the AEA asking for the adoption of a code that requires economists to avoid conflicts of interest and to disclose ties that could create the appearance of a conflict of interest. If you are an economist and would like to sign on, you can email Debbie Zeidenberg (peri at econs dot umass dot edu) by Sunday evening. The full text follows.

We strongly urge the American Economic Association (AEA) to adopt a code of ethics that requires disclosure of potential conflicts of interest that can arise between economists' roles as economic experts and as paid consultants, principals or agents for private firms. As the economics profession serves a prominent role in economic policy, the public's confidence in the integrity of the profession will, in part, depend on how the issue of potential conflicts of interest is addressed. We believe that the AEA, as the main professional organization of the economics profession, should take the lead on creating and adopting a code of ethics to address this issue.

More specifically we propose that the AEA adopt a code modeled on that of the American Sociological Association.<sup>[1]</sup> This code could state that: “Economists should maintain the highest degree of integrity in their professional work and avoid conflicts of interest and the appearance of conflict. Moreover, economists should disclose relevant sources of financial support and relevant personal or professional relationships that may have the appearance or potential for a conflict of interest in public speeches and writing, as well as in academic publications.”

This issue has taken on greater salience as the recent financial crisis has highlighted economists’ potentially conflicting roles that may have affected their real or perceived impartiality as analysts and experts. For example, in an assessment of 19 economists who have played prominent and influential roles in recent public policy debates, Gerald Epstein and Jessica Carrick-Hagenbarth found that 13 out of 19 economists had private financial affiliations indicative of some possible conflicts of interest, but only 5 had clearly and publicly revealed their affiliations.<sup>[2]</sup> A Reuters study of Congressional testimony by academics (many but not all of whom are economists) analyzed “... 96 testimonies given by 82 academics to the Senate Banking Committee and the House Financial Services Committee between late 2008 and early 2010 — as lawmakers debated the biggest overhaul of financial regulation since the 1930s.” They found that “...roughly a third (of the academics) did not reveal their financial affiliations in their testimonies, based on a comparison of the text of their testimonies available on the Congressional committees’ websites with their resumes available online.”<sup>[3]</sup>

Economics is unusual among the social science professions in that it lacks professional ethical codes or guidelines.<sup>[4]</sup> In addition to the American Sociological Association, the American Anthropology Association has a code of ethics. Similarly, the American Psychology Association and the American Statistical Association both have guidelines for ethics. These codes and guidelines vary in several ways: some demand that professional members simply reveal potential conflicts; others demand that they do whatever they can to avoid or end such conflicts.<sup>[5]</sup>

We anticipate that objections may be raised to this proposal for a code of ethics. First, some may argue that this code would be redundant since many academic economists are already working under a conflict of interest policy as put forth by their respective universities. But these codes primarily proscribe conduct that would conflict with the interests of their universities and do not address potential conflicts with respect to the broader public or government. Moreover, many economists are not academic economists and they too should be held to uniform standards of professional conduct.

Second, some economists may believe that listing their paid positions on their CVs and/or biographies constitutes a sufficient act of disclosure. However, we do not think this is sufficient disclosure. It is not reasonable to expect the public to look up each expert’s CV and biography when trying to assess their statements. Our proposed code would require economists to disclose all relevant potential conflicts of interest in all relevant situations, particularly in

academic articles, general media pieces, speeches and testimonies.

In conclusion, we strongly urge that the AEA create and then promote adherence to a professional code of ethics that at a minimum requires transparency with respect to potential conflicts of interest. We believe this would be an important and necessary step toward enhancing the credibility and integrity of the profession.

We urge the AEA to take up this matter at its first opportunity.

[1] The ASA code requires that “Sociologists maintain the highest degree of integrity in their professional work and avoid conflicts of interest and the appearance of conflict”. With respect to transparency, the sociologists’ code requires that: “Sociologists disclose relevant sources of financial support and relevant personal or professional relationships that may have the appearance or potential for a conflict of interest to an employer or client, to the sponsors of their professional work, or in public speeches and writing”.

<http://www.asanet.org/images/asa/docs/pdf/CodeofEthics.pdf>

[2] See [\*Financial Economists, Financial Interests and Dark Corners of the Meltdown: It's Time to Set Ethical Standards for the Economics Profession\*](#)

[3] See Emily Fliter, Kristina Cooke and Pedro Da Costa, “Special Report: For Some Disclosure is Academic” <http://www.portfolio.com/business-news/reuters/2010/12/20/special-report-for-some-professors-disclosure-is-academic#ixzz18sqrBmnL>

[4] See George DeMartino, [The Economist’s Oath: On the need for and Content of Professional Economic Ethics](#).

[5] The [American Psychologists Association](#) declares in their ethics guideline that psychologists should avoid a professional role that could impair their objectivity to carrying out their duties as psychologists. The [American Statistical Association](#) demands that statisticians should not only disclose all conflicts of interest but they should also resolve them.

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## Tax-Exempt Bonds for Beginners

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The Baseline Scenario » 2011 » January 1/3/11 at 11:24 PM James Kwak

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By James Kwak

[Felix Salmon](#) linked to an article by [David Kotok](#) on Build America Bonds (BAB), which reminded

me that I've been meaning to write about them (now that they no longer exist). BAB were introduced in the 2009 stimulus bill. If a state or local government issues BAB, the federal government pays 35 percent of the interest on the bonds; the bondholder pays tax on all the interest, as usual for corporate bonds — but *not* for traditional state or local government bonds (“munis”). BAB were initially only authorized for two years, and were *not* extended in the recent tax cut compromise.

The Republican attack line on BAB is that they “subsidize states in more imprudent-type budget and debt scenarios” (Rick Santelli, quoted in Kotok’s article) or they are “a back-door handout for profligate state and local governments, allowing them to borrow more money while shifting some of the resulting interest costs to the federal government” ([Daniel Mitchell](#)). Well yes, BAB are a subsidy for state and local borrowing. But to criticize them for that without even mentioning the alternative is either uninformed or irresponsible.

Since the beginning of time (OK, the beginning of the income tax), interest on munis has been exempt from federal income tax; this is why munis are also known as tax-exempt bonds. In other words, this is a federal subsidy for state and local borrowing. There are various policy arguments for and against such a subsidy, but the basic fact is that we have a federal system in which power and responsibility are shared between the national, state, and local governments, and this is one way (not the only one) that the national government distributes money to state and local governments. The simplest alternative would be for the national government to simply hold onto its money and decide how to spend it, instead of funneling it to state and local governments to let them decide how to spend it. So the basic principle of the national government distributing money back to the states is one that Republicans should be favorable to.

But the problem is that, like most subsidies effected through the tax code, this one is inefficient. It works like this. Say that, absent the subsidy, a state would have to issue bonds with a yield of 5 percent. (That is, corporate bonds with otherwise equivalent terms issued by a company with an equivalent credit rating would yield 5 percent.) If the bond is tax exempt, however, a buyer in the 35 percent tax bracket would be willing to accept a yield of only 3.25 percent rather than 5 percent (because \$5 before tax is equivalent to \$3.25 after tax.) In that case, the federal government is giving up \$1.75 (per year, assuming a \$100 bond), and it’s all going to the state issuing the bond, which has lower interest costs; the buyer is indifferent between the two scenarios. That’s a subsidy.

In practice, however, it doesn’t work like that. The actual yield on tax-exempt bonds is *higher* than necessary for top-bracket bond buyers to break even. Historically, it’s been about 75 percent of the taxable yields (according to my tax casebook — Graetz and Schenk, 6th ed., p. 224). In the example above, that would be a tax-free yield of 3.75 percent. That means that the \$1.75 subsidy is now being shared between the state and the bond buyer. The state gets \$1.25 in lower interest costs, and the buyer gets \$0.50 in interest she could not have gotten without the subsidy.

And who buys tax-exempt bonds? Rich people. So by funneling the subsidy through this tax exemption, part of it gets siphoned off by the rich. (The \$1.25 in lower interest costs do benefit all

state residents, who would otherwise have to pay higher state taxes; but they would still prefer \$1.75 in lower interest costs.)

BAB were designed to solve this problem. Instead of making the bonds tax-exempt, they are taxable, so in the example above the state would issue them with a 5 percent yield and the buyer would get the same \$3.25 after taxes as if she bought a corporate bond. This time, the federal government simply gives the state \$1.75 in cash, and none of the subsidy gets siphoned off by rich people.

So it's disingenuous to analyze BAB without acknowledging the alternative; you have to compare them to traditional tax-exempt munis. And on a first-order analysis, the hit to the national fisc is the same (\$1.75). The only difference is who gets that \$1.75. With BAB, it's the state as a whole; with tax-exempt munis, rich people get a cut.

Now, it is true that there are second-order effects. In particular, because the subsidy for BAB was set at 35 percent, that did low the effective cost of borrowing for states from \$3.75 to \$3.25 (in the above example). That means that states will borrow more than they would have otherwise. So while the federal subsidy is \$1.75 on a \$100 bond in either case, there will be more of those bonds in a world with BAB — so more borrowing, and more national debt. (This problem, if it is one, could have been solved by setting the percentage lower — say, at 25 percent — so that states' effective borrowing costs would have remained the same.)

Also, because BAB exist, this reduced the supply of munis, increasing demand for munis (since there are still the same number of rich people who want tax-exempt bonds), which [increases prices and reduces borrowing costs](#). So at the margin, BAB did increase state and local borrowing. That was actually the point — this was a stimulus bill, after all — but if you don't like one government subsidizing another government's borrowing, it was a bad thing.

But when people like Daniel Mitchell rail against BAB because they subsidize state and local borrowing, without mentioning tax-exempt bonds, what are we supposed to think? Do they not realize that this subsidy has always been part of the bedrock of the tax code? Or do they know it's there, and are they attacking BAB because they want to preserve a tax exemption that disproportionately favors the rich? I'm not sure which is better.

(By the way, I think this example supports [my interpretation](#) of the tax code. BAB probably got slipped into the stimulus bill because tax policy wonks have for decades thought they would be more efficient than the existing subsidy mechanism. But the constituency for efficient tax policy is not as powerful as the constituency for investments that favor the rich.)

*By James Kwak*

Or perhaps a leading candidate for the Republican presidential nomination.

When it comes to deficits and government spending, the strategy of Republicans in Congress is to assert things that are simply not true or that defy economic logic. [Ezra Klein](#) nails House Majority Leader Eric Cantor misstating the CBO's ten-year projection for health care reform so he can make a false claim about its longer-term effects (ignoring the fact that the CBO explicitly said health care reform would be deficit-reducing in the second decade). The same Republican leadership that rails against deficits is introducing rules that will make it easier to increase the deficit, since tax cuts will no longer have to be paired with offsetting spending cuts.

Apparently, the ability to say things that are not true is something that is learned quite early.

My four-year-old daughter is currently enamored of a series of fairy books. (If they have not entered your house yet, do *not* let them in; bar the doors, do not accept packages, do whatever you need to do.) In these books, the fairies are good, and the goblins are bad. We had read about seven of these books, and one feature of them was that although the heroines (two girls named Kirsty and Rachel who are completely interchangeable because they have no personality) and the fairies are afraid of the goblins, the goblins had shown themselves completely incapable of doing any harm to anyone. As I said to my daughter, "The goblins have never caught a fairy."

Alas, in the next book, the goblins did catch the fairy (although she subsequently escaped). So I said, "We can no longer say that the goblins never caught a fairy."

The next day, my daughter came to me and said: "We can still say the goblins never caught a fairy. Just watch. 'The goblins never caught a fairy.' See? You can still say it!"

She has a bright political future ahead.

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## Who Benefits from Tax Expenditures?

*By James Kwak*

[Ezra Klein](#) points out a new [tax expenditure database](#) from The Pew Charitable Trusts. More attention to tax expenditures — exceptions in the tax code that reduce tax revenue or, put another

way, subsidies channeled through the tax system\* — is always a good thing. But Klein also says something interesting that I don't agree with:

“they’re basically the welfare state for the middle class, cleverly arranged such that they don’t look like the welfare state for the middle class. If every year, the government sent every American — from the richest CEO to the greenest public-school teacher — a check covering 30 percent of their health-care costs, we’d think that a bit weird. We’d think it much weirder if we only sent the checks to the workers who happened to be at firms that offered benefits. . . .

“Yet that’s pretty much exactly what we do. We just hide it in the tax code rather than write it on a check.”

I agree with all of that, except the bit about the middle class. Tax expenditures primarily benefit the rich, for a few reasons.

- First, most of them are deductions from taxable income, which means their value to you is proportional to your marginal tax rate. Not only do rich people have higher marginal rates than middle-class people, but remember that many middle-class people pay exactly zero in income taxes. (The average tax rate for people in the middle income quintile is [2.3 percent](#).) This is true, for example, of the deduction for employer-provided health insurance.
- Second, because most of them are itemized deductions, you only get them if you itemize your deductions—which usually means either that you have a big enough house to have a big mortgage or you have enough income to pay a lot of state and local taxes.
- Third, the size of the deduction is highly correlated with income. To take the most obvious example, rich people have bigger houses, and so they have bigger mortgages. (In another universe, they might buy the same size houses and pay for them with cash — but that’s not our universe.)
- Fourth, there are the tax expenditures that you get on investments, which are disproportionately held by the rich. There’s the tax exemption for life insurance investments. There’s the big one: tax-advantaged investment accounts, including 401(k)s, IRAs, Roth IRAs, 529s, etc. This is even leaving aside the question of whether lower tax rates for capital gains and dividends count as tax expenditures.
- Fifth, there are the tax expenditures for businesses, since in theory those flow to their shareholders, who are disproportionately the rich. (I say “disproportionately” because someone with a net worth of \$1 million has much more than ten times the capital market investments of someone with a net worth of \$100,000.)

Tax expenditures are basically exhibit A for my pet theory of the [tax code](#). And there should be broad support for getting rid of them. But there isn’t, because the median household does get some benefit from the mortgage interest tax deduction. They just don’t realize how much more benefit rich households are getting from it.

\* You can have a debate about what is or is not a tax expenditure. You can even have a debate



about whether the whole concept makes sense, since the identification of something as a tax expenditure presumes some baseline in which that particular loophole doesn't appear. But the latter debate is, in my opinion, philosophical at best. It's pretty clear that the tax code includes some basic principles (like taxing income) and some exceptions (like not taxing a portion of your income equivalent to the amount of mortgage you pay on your house and your vacation house); the latter are tax expenditures.

## Why Is The US Taxpayer Subsidizing Facebook - And The Next Bubble?

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The Baseline Scenario » 2011 » January 1/6/11 at 7:49 AM Simon Johnson

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*By Simon Johnson*

Goldman Sachs is investing [\\$450 million of its own money in Facebook](#), at a valuation that implies the social networking company is now worth \$50 billion. Goldman is also apparently launching a fund that will bring its own high net worth clients in as investors for Facebook.

On the face of it, this might just seem like the financial sector doing what it is supposed to – channeling funds into productive enterprise. The [SEC is apparently looking at the way private investors](#) will be involved, but there are some more deeply unsettling factors at work here.

Remember that Goldman Sachs is now a bank holding company – a status it received in September 2008, at the height of the financial crisis, in order to avoid collapse (for the details, see Andrew Ross Sorkin's blow-by-blow account in [Too Big To Fail](#).) This means that it has essentially unfettered access to the Federal Reserve's discount window, i.e., it can borrow against all kinds of assets in its portfolio, effectively ensuring it has government-provided liquidity at any time.

Any financial institution with such access to such government support is likely to take on excessive risk – this is the heart of what is commonly referred to as the problem of “moral hazard.” If you are fully insured against adverse events, you will be less careful.

Goldman Sachs is undoubtedly too big to fail – in the sense that if it were on the brink of failure now or in the near future, it would receive extraordinary government support and its creditors (at the very least) would be fully protected. In all likelihood, under the current administration and its foreseeable successors, shareholders, executives, and traders would also receive generous help at the moment of duress. No one wants to experience another “Lehman moment.”

This means that cost of funding to Goldman Sachs is cheaper than it would be otherwise – because creditors feel that they have substantial “downside protection” from the government. How much cheaper is a matter of some controversy, but estimates made by my co-author James Kwak (in a



paper presented at a [Fordham Law School conference last February](#)) put this at around 50 basis points (0.5 percentage points), for banks with over \$100 billion in total assets.

In private, I have suggested to leading people in the Obama administration and in Congress that the “too big to fail” subsidy be studied and measured more officially and in a transparent manner that is open to public scrutiny, for example as a key parameter to be monitored by the newly established Financial Stability Oversight Council. Unfortunately, so far they have declined to take up this approach.

However, there is consensus that the implicit government backing afforded to Fannie Mae and Freddie Mac in recent decades allowed them to borrow at least 25 basis points (0.25 percent) below what they would otherwise have had to pay; this is a significant difference in modern financial markets. In [13 Bankers](#) we refuted the view that these Government Sponsored Enterprises were the primary drivers of subprime lending and the 2007-08 financial crisis – that debacle was much more about extreme deregulation and private sector financial institutions seeking to take on crazy risks. But it is still the case that Fannie and Freddie were badly mismanaged – and followed the market in 2005-07 with bad bets based on excessive leverage – in large part because they had an implicit government subsidy. Those institutions should be euthanized as soon as possible.

Goldman Sachs now enjoys exactly the same kind of unfair, nontransparent, and dangerous subsidy; it has effectively become a new form of Government Sponsored Enterprise. Goldman is not a venture capital fund or primarily an equity-financed investment fund. It is a highly leveraged bank, meaning that it borrows through the capital markets most of the money that it puts to work.

As [Anat Admati \(of Stanford University\) and her colleagues tirelessly point out](#), the central vulnerability in our modern financial system is excessive reliance on borrowed money, particularly by the biggest players.

Goldman Sachs is a perfect example. Most of this firm’s operations could be funded with equity – after all, it is not in the retail deposit business. But issuing debt is attractive to shareholders because of the subsidies associated with debt funding for banks, and compelling to bank executives whose compensation is based on return on equity – as measured, this increases with leverage. If they have more debt relative to equity, that increases the potential upside for investors. It also increases the probability that the firm could fail – unless you believe, as the market does, that Goldman is too big to fail.

Social networking firms should be able to attract risk capital and compete intensely. They do not need subsidies in the form of cheaper funding (seen today as a more favorable valuation for Facebook) or in any other form.

Social networking is a bubble in the sense that email was a bubble. The technology will without doubt change forever how we communicate with each other, and this may have profound effects on the nature of our society. But investors will get carried away, valuations will become too high,

and some people will lose a lot of money.

If those losses are entirely equity-financed, there may be negative effects but they will likely be small – in the revised data after the 2001 dotcom crash, there isn't even a recession (i.e., there were not two consecutive negative quarters for GDP).

But if the losses follow the broader Goldman Sachs structure and are largely debt-financed, then the US taxpayer will have helped create another major financial crisis.

And if you think that sophisticated investors at the heart of our financial system can't get carried away and lose money on Internet-related investments, [read up on Webvan](#):

“During the dot-com bubble, Goldman invested about \$100 million in Webvan, the online grocer that never got off the ground and eventually collapsed in bankruptcy.”

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

## The Bill Daley Problem

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The Baseline Scenario » 2011 » January 1/9/11 at 6:43 AM Simon Johnson

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*By Simon Johnson, co-author of [13 Bankers](#) (out in paperback on Monday)*

Bill Daley, President Obama's newly appointed chief of staff, is an experienced business executive. [By all accounts](#), he is decisive, well-organized, and a skilled negotiator. His appointment, combined with other elements of the White House reshuffle, provides insight into how the president understands our economy – and what is likely to happen over the next couple of years. This is a serious problem.

This is not a critique from the left or from the right. The Bill Daley Problem is completely bipartisan – it shows us the White House fails to understand that, at the heart of our economy, we have a huge time bomb.

Until this week, Bill Daley was on [the top operating committee at JP Morgan Chase](#). His bank – along with the other largest U.S. banks – have far too little equity and far too much debt relative to that thin level of equity; this makes them highly dangerous from a social point of view. These banks have captured the hearts and minds of top regulators and most of the political class (across the spectrum), most recently with completely specious arguments about why banks cannot be compelled to operate more safely. Top bankers, like Mr. Daley's former colleagues, are intent of

becoming more global – despite the fact that (or perhaps because) we cannot handle the failure of massive global banks.

The system that led to the crisis of 2008, and the recession that has so severely damaged so many Americans, encouraged excessive risk-taking by major private sector financial institutions and, yes, Fannie Mae, Freddie Mac, and other Government Sponsored Enterprises (although these were most definitely not the major drivers of the crisis – see [13 Bankers](#)).

Today's most dangerous government sponsored enterprises are the largest six bank holding companies: JP Morgan Chase, Bank of America, Citigroup, Wells Fargo, Goldman Sachs, and Morgan Stanley. They are undoubtedly too big to fail – if they were on the brink of failure, they would be rescued by the government, in the sense that their creditors would be protected 100 percent. The market knows this and, as a result, these large institutions can borrow more cheaply than their smaller competitors. This lets them stay big and – amazingly – get bigger.

In the latest available data (Q3 of 2010), the big 6 had assets worth 64 percent of GDP. This is up from before the crisis – assets in the big six at the end of 2006 were only about 55 percent of GDP. And this is up massively from 1995, when these same banks (some of which had different names back then) were only 17 percent of GDP.

No one can show significant social benefits from the increase in bank size, leverage, and overall riskiness over the past 15 years. The social costs of these banks – and their complete capture of the regulatory apparatus – are apparent in the worst recession and slowest recovery since the 1930s.

[Paul Volcker gets it](#); no wonder he has resigned. Mervyn King, governor of the Bank of England, [gets it](#). Tom Hoenig, president of the Kansas City Fed, [gets it](#). Elizabeth Warren, the tireless champion of consumer rights, [gets it](#). Gene Fama, father of the efficient financial markets view, [gets it better than anyone](#).

I discussed the issue in public for two hours at the American Financial Association (AFA) meetings in Denver on Friday with two presidents of the AFA (Raghu Rajan and John Cochrane) and a Nobel Prize winner (Myron Scholes). This is not a left-wing or marginal group – there must have been at least 500 people in the audience (video will be available). The top minds in academic finance understand the problem vividly and are articulate about it – there is no rebuttal to the points being made by [Anat Admati and her distinguished colleagues](#).

This is not a left-right issue – again, look at [the list of people who co-signed Professor Admati's recent letter to the Financial Times](#). This is a question of technical competence. Do the people running the country – including both the executive branch and the legislature – understand economics and finance or not?

If the country's most distinguished nuclear scientists told you, clearly and very publicly, that they

now realize a leading reactor design is very dangerous, would you and your politicians stop to listen? Yet our political leadership brush aside concerns about the way big banks operate. Why?

Top bankers, including Bill Daley, have pulled off a complete snow job – including since the crisis broke in fall 2008. They have [put forward their special interests while claiming to represent the general interest](#). Business and other groups, of course, do this all the time. But the difference here is the scale of the too big to subsidy – measured in terms of its likely future impact on our citizenship and our fiscal solvency, this will be devastating.

Most smart people in the nonfinancial world understand that the big banks have become profoundly damaging to the rest of the private sector. The idea that the president needed to bring a top banker into his inner circle in order to build bridges with business is beyond ludicrous.

Bill Daley now controls how information is presented to and decisions are made by the president. Daley's former boss, [Jamie Dimon, is the most dangerous banker in America](#) – presumably he now gets even greater access to the Oval Office. Daley is [on the record as opposing strong consumer protection for financial products](#); Elizabeth Warren faces an even steeper uphill battle. Important regulatory appointments, such as the succession to Sheila Bair at the FDIC, are less likely to go to sensible people. And in all our interactions with other countries, for example around the G20 but also on a bilateral basis, we will pursue the resolutely pro-big finance views of the second Clinton administration.

Top executives at big U.S. banks want to be left alone during relatively good times – allowed to take whatever excessive risks they want, to juice their return on equity through massive leverage, to thus boost their pay and enhance their status around the world. But at a moment of severe financial crisis, they also want someone in the White House who will whisper at just the right moment: “Mr. President, if you let this bank fail, it will trigger a worldwide financial panic and another Great Depression. This will be worse than what happened after Lehman Brothers failed.”

Let's be honest. With the appointment of Bill Daley, the big banks have won completely this round of boom-bust-bailout. The risk inherent to our financial system is now higher than it was in the early/mid-2000s. We are set up for another illusory financial expansion and another debilitating crisis.

Bill Daley will get it done.

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**Goldman Sachs: “We Consider Our Size An Asset That We Try Hard To Preserve”**

*By Simon Johnson*

To great fanfare, this week Goldman Sachs unveiled the report of its [Business Standards Committee](#), which makes recommendations regarding changes for the internal structure of what is currently the [5th largest bank holding company in the United States](#). Some of the recommended changes are long overdue – particularly as they address perceived conflicts of interest between Goldman and its clients.

What is most notable about the report, however, is what it does not say. There is, in fact, no mention of any issues that are of first order importance regarding how Goldman (and other banks of its size and with its leverage) can have big negative effects on the overall economy. The entire 67 page report reads like an exercise in misdirection.

Goldman Sachs is ignoring the main point of the debate made by – among others – Mervyn King, governor of the Bank of England, regarding why big banks need to be much more financed by equity (and therefore have much less leverage, meaning lower debt relative to equity). On [p.10 of his Bagehot Lecture in October 2010](#), for example, King was quite blunt:

“Modern financiers are now invoking other dubious claims to resist reforms that might limit the public subsidies they have enjoyed in the past. No one should blame them for that – indeed, we should not expect anything else. They are responding to incentives. Some claim that reducing leverage and holding more equity capital would be expensive. But, as economists, such as my colleague David Miles (2010) and Anat Admati and her colleagues (Admati et. al., 2010), have argued, the cost of capital overall is much less sensitive to changes in the amount of debt in a bank’s balance sheet than many bankers claim.”

This King/Miles/Admati critique appears to be gaining a great deal of mainstream traction (see this link for [more on the Miles’ view](#)). At the American Finance Association (AFA) meeting last weekend in Denver, there was much agreement around the main points made by Professor Admati and the leading group of finance thinkers that recently [wrote with her to the Financial Times on this issue](#). Professor Admati’s [slides from Saturday are on the Stanford website](#) (she presented in a Society of Economic Dynamics session, running parallel to the AFA). The Admati, DeMarzo, Hellwig, and Pfleiderer paper examines in-depth, critically, and in the context of current public policy, the mantra that “equity is expensive” for banks; this is [available online](#) – on the same page you’ll also find related pieces of varying length. Reviewing any of these materials is an easy way to get up to speed on why Goldman Sachs’ internal reorganization is little more than irrelevant.

Or perhaps it is a thin smokescreen. The Goldman report does have one revealing statement (on page 1, under their “Business Principles”): “We consider our size an asset that we try hard to preserve.”

As John Cochrane, a University of Chicago professor and frequent contributor to the Wall Street Journal [puts it](#), “The incentive for the banks is to be as big, as systemically dangerous as possible.”

This is how big banks ensure they will be bailed out.

This week's Goldman Sachs report does not contain the phrase "too big to fail" or any serious acknowledgment that Goldman staff at many levels have the incentive to take on a great deal of risk – through increasing their leverage (debt relative to equity) in one way or another.

On this point there is already perfect alignment of insider interests with what their shareholders want – there is no conflict of interest to be addressed. As Professor Admati points out, when a bank is too big to fail, adding leverage raises the return on equity in good times (boosting employee bonuses and the return for shareholders) – and in bad times there is a bailout package waiting.

The Obama administration, House Republicans, and banking executives like to frame the discussion about financial reform in conventional political terms, with the "left" supposedly wanting more regulation and the "right" standing for less regulation.

But this is not a left vs. right issue. John Cochrane is definitely not from the left of the political spectrum; nor is Gene Fama, who signed the [Admati et al letter to the Financial Times](#); nor are numerous other leading finance people who agree with this same position (again, see the list of Admati signatories). Mervyn King is the ultimate apolitical technocrat – as is Paul Volcker, who has been hammering away at these themes for a while.

The financial sector captured the thinking of our top regulators over the past 30 years. It continues to exercise a remarkable degree of sway – as demonstrated in the very small increase in capital requirements agreed upon in the recent Basel III accord.

There was some serious pushback last year against the biggest banks from a few members of Congress – including Congressman Paul Kanjorski and Senators Sherrod Brown, Ted Kaufman, Carl Levin, and Jeff Merkley. (The epilogue to the paperback edition of *13 Bankers* reviews the details.)

Now top people in finance are taking broadly similar positions.

Our big banks have too little capital and are too large. Do not be deceived by the internal alterations and new forms of reporting put forward by Goldman Sachs. At its heart, the problems in our banking system are about insufficient equity in very big banks.

The case against increasing equity in the financial system is very weak – as King/Miles/Admati explain. Most of the opposition to greater equity is in the form of unsubstantiated assertions by people paid to represent the interests of bank shareholders (i.e., executives, lobbyists, and the like).

There is nothing wrong with shareholders having paid representatives – or with those people doing

the job they are paid to do. But allowing such people to make or directly shape public policy on this issue is a huge mistake.

*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.*

## How Times Change

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The Baseline Scenario » 2011 » January 1/15/11 at 12:07 PM James Kwak

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*By James Kwak*

For those waiting, the paperback edition of *13 Bankers* went on sale on Tuesday to little fanfare. That's not surprising; all of the crisis books have been dribbling out in paperback, about 8-10 months after the hardcover editions, to little fanfare. It's a commentary on how quickly times have changed, and also on the fickle nature of the publishing market. While there is still a lot of residual anger and bitterness over the financial crisis — specifically, over the fact that the big banks played a central role in triggering the crisis, then got massive amounts of bailout money, and now have [returned to "health"](#) more quickly than the economy as a whole or the typical household — most people seem resigned to a continuation of the pre-crisis status quo, and what energy remains has perversely gone into railing against the national debt.

The whole story also highlights the importance of timing in publishing. Looking back, we couldn't have gotten any luckier, with the book going on sale during the Senate debate over financial reform and just two weeks before the SEC sued Goldman, which also happened the day that our Bill Moyers appearance aired, which drove our Amazon ranking up to #6. Today we'd be lucky to crack #600.

Back at my law school, there has been much debate about Amy Chua's new book and, more to the point, the excerpt published by the Wall Street Journal entitled "[Why Chinese Mothers Are Superior](#)." Amy Chua, that is, being a Yale Law School professor, and a very popular one at that. As the son of Asian parents (I studied cello at Juilliard prep, by the way) and the father of a half-Asian daughter myself, there's a lot I could say on that topic . . . but I won't.

But I will say this about publishing a popular book. Chua said to the [San Francisco Chronicle](#) (hat tip [Felix Salmon](#)) that the Journal distorted her book:

"I was very surprised. The Journal basically strung together the most controversial sections of the book. And I had no idea they'd put that kind of a title on it. But the worst thing was, they



didn't even hint that the book is about a journey, and that the person at beginning of the book is different from the person at the end — that I get my comeuppance and retreat from this very strict Chinese parenting model.”

Publishing is a business, and if the WSJ “essay” wasn’t what Chua wanted, it was what the Journal wanted, and absolutely what her publisher wanted. What I learned is that when you wade into the world of popular books, you have to understand it’s a business, and you have to take the bad with the good (the Chronicle says that Chua’s book reached #7 on Amazon, and it may be higher by now). You can’t control what people think about your book, or about you for that matter.

*13 Bankers*, for example, was widely received (by people who only read reviews or heard about it from others) as a diatribe against big banks devoted to a single issue: breaking them up. Yet the whole “break up the banks” thing was just half of one chapter. [The Economist](#) panned it as a “conspiracy theory” without pointing out what the conspiracy was supposed to be; people who have read the book know that there’s no conspiracy anywhere in there. I think *13 Bankers* is a serious history book about one of the more important developments in American history in the past half century. But I’m resigned to the fact that most people will think of it (if at all) as a single-issue polemic. At least some people read it. The alternative, when it comes to publishing, is that no one reads it.

**Update:** Two clarifications. First, in the last sentence, by “no one reads it,” I wasn’t feeling sorry for myself about the paperback. Lots of people read *13 Bankers*, and I’m grateful for that. What I meant is that to get that level of success, you have to accept the misunderstandings that come with it.

Second, I didn’t want to sound like I had anything to hide about my upbringing, so I’ll just say this. I got very little pressure from my parents, and I turned out fine. And my daughter has the most “Western” upbringing you can imagine, and she is extraordinarily happy.

## Deficit Hawkoprite Watch

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The Baseline Scenario » 2011 » January    1/17/11 at 2:45 PM    James Kwak

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*By James Kwak*

Sometime this spring, Congress is going to have to raise the debt ceiling or the federal government will face default. Republicans are going to demand many, many pounds of flesh in exchange, ranging from cuts in discretionary spending to rethinking of entitlement programs, which together could undermine the weak stimulative effect of the December tax cuts. Democrats are probably going to give in to at least some Republican demands for two reasons: politically, they fear that

they would be held accountable for a default because the public still associates spending with Democrats, and they hold the White House; pragmatically, they are just not as crazy as the Republican right, and in most negotiations the crazy party gets a better deal.

Of course, this is insane. The deficit problem was created by Congress, through its many votes to increase spending and decrease revenues (otherwise known as taxes). As [James Hamilton](#) put it:

“One of the peculiar embarrassments of the American political process is the fact that Congress votes separately on the deficit and debt, as if they were two different decisions. . . .

“A politician who votes for the spending and tax measures that produced the deficit but against a debt ceiling consistent with these is deliberately wasting taxpayer dollars for no purpose other than to grandstand before voters as a ‘fiscal conservative’. Anyone playing such a game has complete contempt for the intelligence of their constituents.”

I know this is a bit early, but I wanted to get some facts out there in advance of the debate. I picked five major bills in the past decade that have significantly increased the national debt: the 2001 tax cut, the 2003 tax cut, the 2003 Medicare prescription drug benefit, the 2009 stimulus, and the 2010 tax cut. (I left out the Afghanistan and Iraq Wars because it’s hard to pin down Congressional votes specifically authorizing their costs, in part because the famous Senate vote wasn’t actually a vote to go to war, in part because of the peculiar way the costs of the wars were budgeted.)

Then, for each of those bills, I looked up the CBO budget impact estimate made at the time. (Sources are at the bottom of this post.) Their costs, as projected at the time (and hence as knowable by members of Congress), were as follows. The first number is the ten-year cost; the number in parentheses is the portion of that cost through fiscal year 2011. Numbers are in billions.

- 2001 tax cut: \$1,346 (\$1,346)
- 2003 tax cut: \$350 (\$354 — the cut has a tiny deficit-reducing impact in its final years)
- Medicare Part D: \$395 (\$271). Note that I am not including the fact that the cost of this bill was almost immediately reestimated after it passed to be significantly higher, since that was not knowable to members of Congress when they voted.
- 2009 stimulus: \$838 (\$793)
- 2010 tax cut: \$858 (\$374)

That’s a total of \$3.8 trillion — \$3.1 trillion of it hitting the national debt by this year, and hence contributing directly to the need to raise the debt ceiling.

Then I looked up how current senators voted on these bills, whether they were in the Senate or the House at the time. For each senator, I added up how much of the current (2011) debt he could have voted for, and how many he did vote for. So, for example, Daniel Akaka (D-HI) was in the Senate for all five votes, so he was on the floor for \$3.1 trillion in budget-busting bills; he voted for

the last two, so he voted for \$1.2 trillion, or 37 percent of what he could have voted for.

The results are predictable, but I still think worthy of noting, especially with all of the grandstanding that is going to happen.

Overall, current Democratic senators (including Sanders and Lieberman) had the opportunity to vote on \$127 trillion of additional debt, and voted for \$64 trillion, or 50 percent; current Republican senators had the opportunity to vote on \$104 trillion of debt and voted for \$70 trillion, or 67 percent.

The difference would have been greater except for trends in the composition of the Senate. Of current senators, the proportion in each party voting for each bill is as follows:

- 2001 tax cut: Democrats 18%, Republicans 93%
- 2003 tax cut: D 3%, R 94%
- Medicare Part D: D 17%, R 88%
- 2009 stimulus: D 100%, R 5%
- 2010 tax cut: D 77%, R 87%

So the typical Democratic vote pattern is N-N-N-Y-Y (I counted “present” and not voting as no votes — there were very few of these, anyway), which would mean voting for 37 percent of the total debt produced by these bills (just like Daniel Akaka). In fact, thirty-four Democrats were able to vote on all five bills, and twenty of them voted that way.

The typical Republican vote pattern is Y-Y-Y-N-Y, which means voting for 75 percent of the total debt. And, of the twenty-seven Republicans around for all five bills, eighteen of them voted that way.

The reason that the Republican-Democratic “debt responsibility” percentages are 67-50 instead of 75-37 is that not all senators have been in Congress for the past decade, and most of the ones who have only been there for a few years are Democrats. So there are many Democrats who were only in Congress for the last two votes, on which they typically voted Y-Y (100%), and a few Republicans who were only there for the last two votes, on which they typically voted N-Y (32%). So the facts that the Democrats’ budget-busting bills came later, and that I’m only looking at current senators, make the Democrats seem more profligate than their party has been as a whole, and vice-versa for Republicans.

The bottom line: As a party, the Republicans who will be railing against fiscal irresponsibility and threatening to block a raise in the debt limit are the irresponsible ones themselves who created the need to raise that debt limit. The Democrats can claim to be somewhat less irresponsible; more to the point, perhaps, insofar as they did vote to raise the debt, at least their current behavior (assuming that most support the administration and vote to raise the debt limit) is at least

consistent with their past votes.

Of course, it's more fun looking at an individual level. And the only people who can claim not to be responsible for the national debt — at least not via any of these five bills — are the newly elected members (except Rob Portman and Pat Toomey, who voted down the line to increase the debt as Congressmen) and Tom Coburn, who joined the Senate in 2005 and voted against both the stimulus and the 2010 tax cut.

By contrast, Republican leaders Mitch McConnell and Jon Kyl each voted for \$2.3 trillion of debt (75 percent), yet will somehow try to argue that the need to raise the debt ceiling is not their fault.

On the flip side, the only people who voted for all \$3.1 trillion of debt are Ben Nelson (D-NE) and Susan Collins (R-ME), generally considered moderates. (Liberals think Nelson is a closet Republican, and conservatives think Collins is a closet Democrat.) Following Nelson and Collins, at \$2.8 trillion, are Max Baucus (D-MT), Dianne Feinstein (D-CA), Mary Landrieu (D-LA), and Olympia Snowe (R-ME) — also generally considered centrists. One inference you could draw is that bipartisan centrists are the last thing we need, since they vote for both tax cuts and spending increases. Of course, the December tax cut is Exhibit A in the problem with bipartisan compromise, at least from the perspective of the deficit.

Finally, I realize that Hamilton's post was actually a quotation from a [post he wrote in 2006](#), when the political situation was reversed; the Bush administration was trying to raise the debt ceiling so the government could continue functioning, and the Democrats voted against it. But I don't think that it's fair to say the Democrats then were the same as the Republicans today.

There are two different issues here. One is the political issue of trying to score points by blocking an increase in the debt ceiling that is necessary to avoid chaos in the global economy. That is irresponsible today, and it was irresponsible then, I agree.

The other is the substantive issue of whether, in fact, you created the national debt in the first place and should behave accordingly. Hamilton tried to nail the Democrats in 2006 by pointing out that they voted to spend \$3 billion on the Low-Income Home Energy Assistance Program on the same day that they voted against an increase in the debt ceiling. But that's a pretty weak argument when the Democrats overwhelmingly voted against the 2001 tax cut, the 2003 tax cut, and the Medicare prescription drug benefit, with a total ten-year cost of \$2.1 trillion — seven hundred times as much as they spent on the Low-Income Home Energy Assistance Program. I don't think you can demand that someone vote against every spending increase and every tax cut to avoid being called a hypocrite. And in 2006, the Democrats at least could claim that they were not responsible for the recent ballooning of the national debt. The Republicans can make no such claim today (except for Tom Coburn, Rand Paul, Marco Rubio, and a few other newbies).

Anyway, here's a [spreadsheet](#) with all the data if you're interested. Feel free to reuse.

## Sources

Since the Senate generally votes on a bill multiple times, it is not always clear which is the most important vote. Usually there is at least one vote to pass the bill in the first place and another to pass the version that comes out of conference committee. This being the Senate, however, sometimes the cloture votes are the ones where the bill actually stands a chance of passing. I've indicated which vote I used below. Using different votes might yield slightly different results, but only slightly since the votes don't move around that much.

- 2001 tax cut: [CBO estimate](#) — [Senate vote](#) (to approve conference report)
- 2003 tax cut: [CBO estimate](#) — [Senate vote](#) (to approve conference report — this was a 50-50 vote that was decided by Vice President Cheney)
- Medicare prescription drug benefit: [CBO estimate](#) — [Senate vote](#) (a procedural motion that required sixty votes and only got sixty-one)
- 2009 stimulus: [CBO estimate](#) — [Senate vote](#) (to approve conference report)
- 2010 tax cut: [CBO estimate](#) — [Senate vote](#) (the final vote in the Senate)

## Tim Geithner: Never Again, Until The Next Time

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The Baseline Scenario » 2011 » January    1/18/11 at 6:43 AM    Simon Johnson

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*By Simon Johnson*

In a [column now running on Bloomberg](#), I review the new Inspector General report on what exactly happened during the “Citi Bailout Weekend” of late November 2008.

The big question lurking in the background is how acutely we face a problem of Too Big To Fail (TBTF) today, i.e., the perception in the credit markets that very big banks will be supported in a crisis, therefore enabling these banks to borrow more cheaply during a boom - and thus enabling them to become larger and increasing their debt relative to equity (leverage).

According to the report, Treasury Secretary Tim Geithner now completely backs away from claims that the Dodd-Frank reform legislation ended TBTF.

Standard and Poor's appears to be on the right track with their latest revised [Bank Ratings methodology](#) – presuming that “potential government support” is, going forward, always available to megabanks. This is exactly the conclusion of [13 Bankers](#). We should worry greatly about the implications.

*To read the full column, [click here](#), or cut and paste this address:*

## Deficit Hawkoprite, Eric Cantor

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The Baseline Scenario » 2011 » January 1/19/11 at 5:34 PM James Kwak

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*By James Kwak*

Eric Cantor, House Republican Majority Leader, said the Republicans will [demand spending cuts](#) in exchange for the votes necessary to raise the debt ceiling.

Eric Cantor, member of Congress, voted for:

- The 2001 tax cut
- The 2003 tax cut
- The 2003 Medicare prescription drug benefit
- The 2010 tax cut

In other words, of the big five budget-busting measures of the past decade, the only one he didn't vote for was the 2009 stimulus. In other words, he had the opportunity to vote for \$3.1 trillion of the 2011 debt, and he voted for 75 percent, or \$2.3 trillion — just like most Republicans who were in Congress for those five votes.

For explanation and sources, see [this post](#).

## The Financial Stability Oversight Council Defers To Big Banks

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The Baseline Scenario » 2011 » January 1/20/11 at 7:56 AM Simon Johnson

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*By Simon Johnson*

As required by Section 123 of the Dodd-Frank financial reform legislation, Treasury Secretary Tim Geithner, as chair of the Financial Stability Oversight Council (FSOC), has released an assessment on the costs and benefits of potentially limiting the size of banks and other financial institutions. This report, four-and-a-half pages in a longer “Study of the Effects of Size and Complexity of Financial Institutions on Capital Market Efficiency and Economic Growth”, is represented as a survey of the relevant evidence that should guide policy thinking on this issue.

Mr. Geithner's team conclude rather vaguely "there are both costs and benefits to limiting bank size", and consequently "This study will not make recommendations regarding limits on the maximum size of banks, bank holding companies, and other large financial institutions."

This is an analytically weak report that presents a skewed and incomplete assessment of the evidence. Given that the paper was prepared by some of the country's top experts, who are well aware of the facts, the only reasonable inference is that our leading relevant officials prefer not to take the Dodd-Frank Act seriously with regard to reducing systemic risk. Instead, on all major points, the Financial Stability Oversight Council is allowing the big banks to prevail – and to pursue whatever global expansion plans they see fit.

Given Treasury's attitude during the financial reform debate of 2009-10, this is not entirely surprising. Still there are three major issues with the substance report that should be considered particularly embarrassing to Mr. Geithner and his colleagues.

First, on whether large banks benefit the broader economy, the authors neglect to mention even the most basic facts regarding the increase in the size of our largest banks in recent years. As a result, the entire discussion of bank size in this report reads as it is completely divorced from current economic and political realities.

The largest six bank holding companies in the US had assets valued at 64 percent of GDP at the end of the third quarter of 2010 (the latest available comprehensive data). The same banks accounted for just less than 55 percent of GDP at the end of 2006 and a mere 17.1 percent of GDP in 1995. (All the numbers in this column are updates from what we presented in *13 Bankers*, using the latest revised official sources.)

The assets of Chase Manhattan in 1995 amounted to 4.1 percent of GDP. The assets of JP Morgan Chase, as measured officially, were 14.5 percent of GDP in 2010; if we included their off-balance sheet assets (including derivatives), this total would be substantially higher. There has been a similar increase in all the Big Six Banks.

The balance sheet of Goldman Sachs, for example, increased from 1.3 percent of GDP in 1995 to around 6.2 percent of GDP at the end of last year ([based on this week's report](#)); by the firm's measure, assets expanded 7 percent from the end of 2009 to the end of 2010.

The central issue with regard to size that should be before the FSOC is not the presence or absence of economies of scale in banking generally, i.e., whether a bank becomes more efficient as it increases from, say, \$100m to \$100bn in total assets. The pressing policy priority is how to assess what has happened to efficiency within our very largest banks – and the precise way that has benefited the broader economy (or not).

Second, the report's survey of the empirical literature is highly selective to say the least, ignoring –



for example – almost all of the research we cite in *13 Bankers*. It also fails to mention the 2007 Geneva Report, “International Financial Stability,” co-authored by former Federal Reserve vice chair Roger Ferguson, which found that banking consolidation had not led to efficiency gains, economies of scale (at least above a low threshold), or economies of scope.

The report places a great deal of weight instead on [a single unpublished working paper from the St. Louis Fed. by David Wheelock and Paul Wilson](#). This is an interesting paper by serious researchers, and one that we placed in the context of the literature on p.212 of *13 Bankers* (see also footnote 69 on p.272; all page numbers refer to the hard cover edition.) But this paper is based on a very particular econometric specification, i.e., a way of writing down the equations that put structure on the data that is far from convincing. In particular, it is hard – perhaps impossible – in their framework to determine the “true” efficiency of banks, compared with the effects of various kinds of government subsidies implicit in being “too big to fail” and therefore having cheaper access to funding.

In addition, the report fails to note that while the Wheelock and Wilson paper was last revised in October 2010, it uses data only through 2006. A similar data limitation or worse holds for all the other papers that FSOC cites approvingly (e.g., by Gouhua Feng and Apostolos Serletis, who use data over 2000-05.)

Basing banking policy on data from just part of any credit cycle is unwise, to say the least (and not at all what the authors of these underlying papers are recommending). And it is very strange that responsible officials would think we should draw any relevant inference for our current situation by cutting off the information in the mid-2000s, i.e., before the crisis and without the ability to reassess who made and who lost what kind of money (and how government bailouts affect the relevant statistics).

This is akin to saying, “let’s pretend there was no financial crisis in 2008-09.” It makes no sense, unless you wish to view today’s megabanks in the most favorable possible light.

Third, the FSOC is completely ignoring the important work done at the Bank of England on bank size, “too big to fail,” and closely related issues. For example, nowhere in the longer report do they cite the work of Andrew Haldane and his colleagues who have financial stability responsibilities in the UK. The October speech by Mervyn King, governor of the Bank of England, is also a glaring omission – see my NYT Economix column [last week for the details](#).

And it is simply shocking that the longer report nowhere cites [the definitive work of Anat Admati, Peter M. DeMarzo, Martin R. Hellwig, and Paul Pfleiderer](#) on the need to greatly increase equity in the banking system, i.e., reduce leverage (debt relative to equity) through much higher capital requirements, because this is an essentially zero cost way to make financial intermediation safer. This is central to the broader discussion of size and complexity, because it speaks directly to the issue of whether banks’ buffers against losses are likely to prove adequate as we move forward.

There is a pattern of official behavior here. Central banks in other industrialized countries are at least beginning to confront the ideology that supports the unfettered and undercapitalized growth big banks.

In contrast, the Treasury, the Federal Reserve, and now the FSOC are [distorting the evidence](#) to accommodate the views of [Jamie Dimon](#), [Bill Daley](#), and other executives who want to build bigger, increasingly global, highly leveraged, and much more dangerous banks.

*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 republish the entire column, please contact the New York Times.*

## **"Fannie Mae Made Me Do It"**

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**The Baseline Scenario » 2011 » January**    1/20/11 at 11:07 PM    Simon Johnson

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*By Simon Johnson. This post is the first few paragraphs of a column [now available at Project Syndicate](#).*

The United States continues to be riven by heated debate about the causes of the 2007-2009 financial crisis. Is government to blame for what went wrong, and, if so, in what sense?

In December, the Republican minority on the Financial Crisis Inquiry Commission (FCIC), weighed in with [a preemptive dissenting narrative](#). According to this group, misguided government policies, aimed at increasing homeownership among relatively poor people, pushed too many people into taking out subprime mortgages that they could not afford.

This narrative has the potential to gain a great deal of support, particularly in the Republican-controlled House of Representatives and in the run-up to the 2012 presidential election. But, while the FCIC Republicans write eloquently, do they have any evidence to back up their assertions? Are poor people in the US responsible for causing the most severe global crisis in more than a generation?

Not according to Daron Acemoglu of MIT (and a co-author of mine on other topics), who presented his findings at the American Finance Association's annual meeting in early January. ([The slides are on his MIT website](#).)

*To read the rest of this column, please [click here](#) or cut and paste this address: <http://www.project-syndicate.org/commentary/johnson16/English>.*

## There Are Still No Fiscal Conservatives In The United States

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The Baseline Scenario » 2011 » January 1/26/11 at 4:27 AM Simon Johnson

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*By Simon Johnson*

Following President Obama's State of the Union address, there is a great deal of discussion about whether we might now be edging our way towards fiscal responsibility.

Unfortunately, most of our political elite – both left and right – is still living in a land of illusions. They cannot even seriously discuss what would be required to bring our true fiscal position under control – remember that most of the recent damage to our collective balance sheet was done by big banks blowing themselves up. No one who refuses to confront the power of those banks can be taken seriously as a fiscal conservative.

Even those interest groups that prominently espouse fiscal responsibility refuse to confront this reality. [There are no fiscal conservatives in the United States](#); at this stage it is all pretence.

Pretence is apparently all we are likely to get, as long as the money keeps rolling in ([see Argentina for details](#)).

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## Mittens or Dinner?

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The Baseline Scenario » 2011 » January 1/26/11 at 9:38 AM James Kwak

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*By James Kwak*

Although I have written many blog posts pointing out that people are not actually rational maximizers (that is, they don't know what their preferences are, and even if they did they don't make rational choices to maximize those preferences), I actually try to be a rational maximizer as much as possible. That is, when making decisions, I try to think about what my expected utility (admittedly, some vague combination of immediate happiness, reflective happiness, reduction in stress, and increase in leisure time\*) is from each course of action and decide accordingly. When I was working and very, very busy, this translated into the \$25 rule: for personal stuff, I valued my time at \$25 per hour.\*\* So if I had to return something to the store, but it cost \$10 and it would take me half an hour, I wouldn't bother.

The problem is that although we human beings are not terrible at comparing expected utility across

amounts (e.g., more french fries vs. less french fries<sup>\*\*\*</sup>) or within narrow product categories (e.g., LG vs. Samsung TVs), we are very bad at comparing expected utility across different categories of experience and products (e.g., skiing for a day versus a new pair of good earbuds). I just read "[Coherent Arbitrariness](#)," a 2003 QJE paper by Dan Ariely, George Loewenstein, and Drazen Prelec that makes this point beautifully, with some interesting implications. (That link requires some sort of affiliation, but you can just Google it as well.)

The content is probably already familiar to anyone who knows some behavioral economics. The basic point is that our valuations of goods can be manipulated by arbitrary anchors. In one experiment, they first asked people if they would be willing to pay more or less than the last two digits of their social security numbers (in dollars) for each of six common consumer goods, and then asked what their willingness to pay was for each good. (Both answers could determine whether the transaction would actually take place at one of those price points.) People with high SSNs were willing to pay roughly three times as much as people with low SSNs. At the same time, their relative orderings between goods made sense (WTPs were higher for rare wine than for average wine<sup>\*\*\*\*</sup>). Other experiments show that relative orderings over various quantities of the same thing make sense. So the point is that once people's anchors are set, they will look like they have orderly demand functions, but those anchors can be completely arbitrary. Another experiment shows that market forces (after anchoring, participants bid for things) do not cause convergence between people with different anchors.

The implication they draw for financial markets may be obvious, but it touches on something that has interested me for a while. If preferences are susceptible to anchoring but more or less orderly thereafter, then market prices will respond predictably to changes in information, but they have no fundamental level:

"Thus, studies showing that the market follows a random walk are consistent with fundamental valuation, but are insufficient to demonstrate it; indeed, Summers presents a simple model in which asset prices have a large arbitrary component, but are nevertheless serially uncorrelated, as predicted by fundamental valuation."

I say this is interesting because, on the one hand, I accept the random walk studies (and I personally believe I have no ability to predict where any security price is going tomorrow), but on the other hand I think that any idea that markets have fundamental levels is flawed. For example, housing prices are [still falling](#). Some people try to predict how far they will fall by looking at the Case-Shiller Index and figuring out where the long-term trend line will be. But how do you look at a chart and figure out what the right value is? What if there has been something different about the market over the last one hundred years from the market today? It's really a fool's errand.

On the other hand, in your personal life, you should be aware of anchoring, because it can help you use your money more wisely. For example, for several years I would complain about being cold in the winter in New England. I was coldest when I was walking my dog, because then I had to be outside for half an hour at the time, and my hands were one of the coldest parts of my body. Finally

I asked my wife to buy me the warmest mittens she could find for Christmas, and since then my hands have never been too cold. They probably cost \$150 or something, but in the three winters since then they have probably given me something like one hundred hours of extra warmth, and they should give me at least another three hundred hours. That comes to less than a penny per minute of warmth (and less than a quarter per walk with the dog), and I would gladly pay more than that. Compare that to, say, two nice dinners that last for a total of four hours, and there's no contest.

But until I asked for the mittens, I was overconsuming dinners and underconsuming warm mittens — because I was inferring my own preferences from market prices. In short, you are different from the average person, so at the same price level, some things will give you a lot of utility and some will give you not very much. The more you are aware of that, the happier you will be.

\* Why isn't money on the list? Because I usually try to translate money into some combination of reduction in stress and increase in leisure time. That is, the more money I have, the less I have to work in the future or the less I will worry about money.

\*\* You might say this is irrational because my after-tax wage was much higher than \$25. But I had no way of cashing in more time for more money. And also, when you're already working too much the psychological disutility of more work can be pretty high.

\*\*\* Actually, this isn't a great example. We often eat too many french fries because we assume more is better, and we are susceptible to anchoring by portion size.

\*\*\*\* Another interesting case, since rare wine does no better than average wine in blind taste tests. But presumably people are paying for some utility other than taste when they buy rare wine.

## President Obama and Big Business Get On Well – But When Will That Produce Jobs?

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*By Simon Johnson*

President Obama is embarked on a major charm offensive with regard to the business sector, as seen for example in the appointments of Bill Daley (ex-JP Morgan; now White House chief of staff) and Jeff Immelt (still head of GE, now also the president's top outside economic adviser). This should not be an uphill struggle – much of the corporate sector, particularly bigger and more global businesses, is doing well in terms of profits and presumably C-suite remuneration.

But when exactly will this approach deliver jobs and reduce unemployment? And it store up risks

for the future?

Republican rhetoric over the past two years was relentless on one point – that the Obama administration was anti-business. Supposedly this White House attitude undermined private sector confidence and limited investment.

In reality, the opposite was the case.

Relative to any post-war recession, the rebound in profits during the Obama administration has been dramatic. To be sure, the end of 2008 was shocking to many entrepreneurs and executives – as credit was disrupted in much more dramatic fashion than they thought imaginable. Large and immediate cuts in employment followed.

But then the government saved the failing financial sector. The means were controversial but the end was essential – without private credit, the US economy would have fallen far and for a long time.

And profits rebounded almost at once. The financial sector recovered quickly on the back of implicit guarantees provided to our largest banks – really the only bad quarter was at the end of 2008 (hence the angst about bankers' bonuses in 2009). But the nonfinancial sector has done even better. Profits for those private businesses fell by no more than 20 percent from top-to-bottom in the cycle and in 2010 through the third quarter (the latest available data in the BEA series) profits were back at the level of 2006. After the deep recessions of the early 1980s, for example, it took at least three times as long for profits to come back to the same extent. (I went through this comparison in more detail [last week for the NYT's Room for Debate](#)).

And investment in plant and equipment has also recovered fast – this was the one bright part of the domestic economy in the past two years (with the other good relatively source of news being exports). Look around at the places you work and where you do business (or shop). Is there any indication they have cut back on information technology spending recently?

Overall, the policies of late 2008 and early 2009, including the much-debated fiscal stimulus, protected corporate sector profits to an impressive degree — despite the fact that this was the steepest recession of the past 70 years, profits fell only briefly and seem likely to be just as strong going forward as they were pre-crisis. Large global American-based companies, in particular, are well positioned to take advantage of growth in emerging markets such as India, China, and Brazil.

But the link between corporate performance — measured in terms of profit or executive pay for U.S. companies — and domestic employment has fundamentally changed in recent decades. At the very least, employment responds slower now than in previous cycles when output and sales recover. You should look immediately and regularly at [this chart from the Calculated Risk blog](#). As the picture shows so vividly, we are still waiting for employment to turn back up decisively; compared with previous recessions, the delay is simply stunning.

Ideally, in a situation like this, we'd provide more stimulus to the economy in some form. But our monetary policy is already close to exerting its maximum efforts, and the scope for using fiscal policy was undermined by high deficits during the "boom" years of the 2000s – so there is no safe fiscal space for action (even if the politicians could agree on what to do.)

We are reduced to waiting for the private sector to recover enough to want to take on new employees. No one has a good answer for why this is so slow – perhaps because it is so easy and so cheap to hire workers in those very emerging markets that are now booming, or perhaps because the skill mix available at prevailing wages in some parts of the US is not exactly what employers want.

Or perhaps there are artificial barriers to entry at work, meaning that companies can effectively keep out new entrants – thus keeping profits artificially high and, at the sectoral level, limiting employment. The constraints on entrepreneurship in our post-credit crisis economy need careful scrutiny. Hopefully, the administration's charm offensive will not prevent it from enforcing our anti-trust laws, which were more than slightly neglected in the Bush years.

Listening attentively to the nonfinancial sector makes sense in this situation; in return, corporate leaders need to focus on creating jobs in the United States.

But bending over backwards to accommodate the wishes of the financial sector is exactly what got us into this mess to start with. Allowing our largest banks to become even bigger and more dangerous would be a very bad mistake.

*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.*

## Davos: Two Worlds, Ready Or Not

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The Baseline Scenario » 2011 » January 1/29/11 at 4:27 AM Simon Johnson

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*By Simon Johnson*

On the fringes of the World Economic Forum meeting in Davos this week, there was plenty of substantive discussion – including about the dangers posed by our "too big to fail"/"too big to save" banks, the consequences of widening inequality (reinforced by persistent unemployment in some countries), and why the jobs picture in the U.S. looks so bad.



But in the core keynote events and more generally around any kind of CEO-related interaction, such themes completely failed to resonate. There is, of course, variation in views across CEOs and the people work intellectual agendas on their behalf, but still the mood among this group was uniformly positive – it was hard to detect any note of serious concern.

Many of the people who control the world's largest corporations are quite comfortable with the status quo post-financial crisis. This makes sense for them – and poses a major problem for the rest of us. The thinking here is fairly obvious. The CEOs who provide the bedrock of financial support for Davos have mostly done well in the past few years. For the nonfinancial sector, there was a major scare in 2008-09; the disruption of credit was a big shock and dire consequences were feared. And for leaders of the financial sector this was more than an awkward moment – they stood accused, including by fellow CEOs at Davos in previous years, of incompetence, greed, and excessively capturing the state.

But all of this, from a CEO perspective, is now behind them. Profits are good – this is [the best bounce back](#) on average in the post-war period; given that so many small companies are struggling, it is reasonable to infer that the big companies have done disproportionately well (perhaps because their smaller would-be competitors are still having more trouble accessing credit). Executive compensation at the largest firms will no doubt reflect this in the months and years ahead.

In terms of public policy, the big players in the financial sector have prevailed – no responsible European, for example, can imagine a major bank being allowed to fail (in the sense of defaulting on any debt). And this government support for banks has translated into easier credit conditions for the major global corporations represented at Davos.

The public policy issue of the day, from the point of view of such CEOs, is simple. There needs to be sufficient fiscal austerity to strengthen public balance sheets – so that states can more effectively stand behind their banks in the future, and to keep currencies from moving too much. Leading bankers, in particular, insisted on the paramount importance of providing unlimited government support to their sector during 2008-09; now they insist with equal or greater vigor that support to all other parts of society be curtailed.

This is where cognitive dissonance creeps in. Most CEOs feel that the provision of general public goods is not their responsibility, although they are very happy to help guide (or capture) the provision of public goods specific to their firm.

But it is reckless decisions by some in the financial sector that produced the crisis and recession – this is what accounts for the 40 percent of GDP increase in net government debt held by the private sector in the United States (to be clear: it's the recession and mostly the consequent loss of tax revenue). And CEOs are happy to lead the charge both against raising taxes and in favor of deficit reduction.

This adds up to public goods being weak and so much under pressure around the world. No one can put significant resources to work helping to bring down unemployment. No one is seriously addressing the loss of skills faced by the long-term unemployed. No one is offering real resources to help improve education for lower-income children or adults who did not finish high school.

Self-anointed “fiscal conservatives” claim the budget issues we face are all about discretionary nonmilitary spending. This is nonsense. The U.S. faces an incipient fiscal crisis (a) in the shorter term, because of what the big banks did and what they are likely to do in the future, and (b) over the next few decades, if we fail to control rising health care costs (both in general and as funded by government budgets).

The gap between the CEOs’ world and the real world should be bridged by the official sector. But where are the politicians and government officials who can explain what we need and why? Who can confront the CEOs in the highest profile public forums, and push them on the social responsibility broadly defined?

The biggest disappointment at Davos was not the attitude of the corporate sector; these people are just doing their jobs (as they see it). To the extent the U.S. or eurozone official sector showed up at all, it continued to demonstrate the deepest levels of intellectual capture. The reasoning seems to be: As long as we do what the big banks and big firms want, everything will turn out all right. There was zero high-profile public debate at Davos this week on anything related to this way of seeing the world.

Corporate Davos was borderline exuberant. Even if a deeper crisis looms, does the global business elite really care?

## My Most Libertarian Post Ever

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The Baseline Scenario » 2011 » January 1/30/11 at 4:38 PM James Kwak

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*By James Kwak*

(Yes, I know that isn’t saying much.)

Most people think that Fannie Mae and Freddie Mac had something to do with the financial crisis. Some people think that they were the major reason the crisis happened, which (to them) proves that activist government policy was the cause of the crisis. Other people, including me, think they were a modest contributing factor because they did buy a lot of securities that were backed by subprime loans, but they were well behind the curve when it came to mortgage “innovation” and the creation of toxic assets. But that’s not the question here.

The question now is what to do about them. Although they had been private, profit-seeking companies for forty years, they were taken over by government regulators in September 2008 when they had become clearly insolvent, and are still being operated in conservatorship. Because Fannie and Freddie were very, very long housing, they have suffered massive losses since the financial crisis began. But because the private mortgage securitization market has collapsed, they are the bulk of the secondary mortgage market at the moment, which means the housing market could collapse without them.

On [Planet Money](#) a couple of weeks ago, Bethany McLean and Joe Nocera took the cutely counter-intuitive position that the most bizarre mortgage product is the thirty-year fixed mortgage — and that it wouldn't exist without Fannie and Freddie. Basically, their argument goes like this: Borrowers like thirty-year fixed-rate mortgages, but lenders should hate them. Because of the fixed rate, they carry interest rate risk, meaning that if market interest rates rise the value of the mortgage asset will fall. (If you hold it to maturity, you will still get the cash you expected, but if you are a traditional lender you are funding the mortgage with short-term liabilities, and the interest rates you pay on those will go up — as happened to the entire S&L sector in the 1970s.) Furthermore, they carry credit risk, since lots of things can happen to borrowers over thirty years, and as a result they might not pay you back.\* So, according to McLean and Nocera, no banker in her right mind would sell such a product — not, that is, without Fannie and Freddie there to buy the mortgage and take the risk off her hands.\*\* Their punch line is that although Americans like to complain about government intervention in the mortgage market, Americans also want their thirty-year fixed-rate mortgages, and you can't have one without the other.

But this argument doesn't make complete sense to me. If thirty-year fixed-rate assets are bad, that means no one would buy thirty-year U.S. Treasury bonds, yet people do (at [4.53 percent](#)). A bank could originate a thirty-year fixed-rate mortgage and just buy an interest rate swap to hedge the interest rate risk. And if banks didn't lend money to people because lots of things can happen to them that might interfere with their ability to repay, then they would never make business loans. Most businesses have much more volatile cash flows than someone with a good job. The first hedge against credit risk is the fact that you're making lots of different mortgages to lots of different people, so you diversify away the specific risk in any given household. Now, it's harder to hedge market risk — in this context, macroeconomic factors — especially if you do your lending in a local market. So the second hedge is that the mortgage is secured by the house, which means that as long as you have a reasonable loan-to-value ratio the bank is probably safe. And in any case, if you're in traditional banking, macroeconomic risk is just part of your business.

The above also assumes that lenders are holding onto their loans. If they can sell their thirty-year fixed-rate mortgages on the secondary market, then the "problem" is completely off their hands. Yes, Fannie and Freddie are big players in the secondary market. But there's no law of nature that says you can't have a secondary market without them. What you need are standards, so that mortgages (or mortgage-backed securities) can be traded without investors having to look into every single mortgage. (For example, the development of standards for corn in (I think) the

nineteenth century made it possible for different farmers to dump their corn into the same bin at one end of the railroad and for different buyers to take their corn out of the same bin at the other end — without every buyer having to verify her seller's corn.) That's one thing Fannie and Freddie provided with the conforming mortgage standards, but again, there's no law that says that standards have to be set by companies with implicit government guarantees.

In fact, until recently we had a big secondary market for mortgages that didn't rely on Fannie and Freddie — private mortgage securitization. Now, yes, I know as well as anyone that this turned out to be a big disaster. It turned into a disaster because the "standards" were set by credit rating agencies. But instead of setting strict criteria for underlying mortgages and then verifying that the actual mortgages met those criteria, the rating agencies used statistical models that attempted to predict how new, varied bundles of mortgages would perform, and they didn't even do a very good job of verifying that the actual mortgages were consistent with the models. So in the end you had a secondary market that was vastly overpaying for crappy mortgages, and when everyone realized that, the market vanished.

So let's think about what might happen if Fannie and Freddie didn't exist. People would still want thirty-year fixed-rate mortgages, so some bank would try to originate them. That bank might just hedge the interest rate risk with interest rate swaps and hold onto the credit risk. Banks held onto the credit risk during the postwar boom. [**Fixed, see below.**] In [1960](#), for example, banks and thrifts held about \$116 billion in home mortgages; government-sponsored enterprises held about \$3 billion, with about zero in mortgage pools.\*\*\*

Alternatively, that bank might try to package and resell mortgages on the secondary market. It doesn't really matter if they are sold as packages of loans or as tranching mortgage-backed securities. The important thing is that there are verifiable and verified standards so that investors don't have to inspect all the mortgages. That could be a private sector function, or alternatively there could be a government agency to define conforming mortgage standards and verify that the loans in a given pool comply with those standards. But the government agency doesn't also have to be buying the mortgages. If investors can be sure that mortgages are what they say they are, then someone will buy them: pension funds, insurance companies,\*\*\*\* hedge funds, rich people, etc.

Now, the question is, how much will they pay? The Planet Money episode with McLean and Nocera cited Bill Gross of PIMCO saying he would demand an extra three percentage points in yield for a mortgage without a Fannie/Freddie credit guarantee. Although Bill Gross is no doubt one of the smartest investors in the world, there are a couple of reasons to doubt this.

There are at least two ways to estimate what mortgage rates would be without Fannie and Freddie. First, we can look at Fannie and Freddie themselves. Until 2008, they were profit-seeking companies, meaning that they were already paying as little for mortgages as they could. Their competitive advantage in the market was their implicit government guarantee — people thought that, in a crisis, the federal government would bail them out and protect them from default — which meant they could borrow money more cheaply than, say, banks. Without Fannie and Freddie, the

new replacement buyers would have higher funding costs, so the increase in the yields they demand should be roughly the same as the difference between their fundings costs and those of Fannie/Freddie. Major banks these days have credit ratings around A, which means they pay about 80 basis points more for seven-year debt than do Treasuries. (I use seven years because that's roughly the average time before a mortgage is paid off.) Even if Fannie and Freddie were paying the same yield as the Treasury Department, that means that mortgage rates would only be about 80 bp higher without them.

Second, we can look at the spread between conforming mortgages and jumbo mortgages (which are too big to be bought by Fannie and Freddie). A quick search yields [this paper](#) by Anthony Sanders, which cites several other studies (see Table 1) that show the spread to be between 16 and 40 basis points.

(Now, Bill Gross might still be right. In today's market, if a mortgage isn't guaranteed by Fannie or Freddie, there must be something wrong with it, so maybe you should demand 300 bp more to buy it. But that's an adverse selection problem that wouldn't exist without Fannie and Freddie.)

So according to the back of the envelope at least, a world without Fannie and Freddie would not send mortgage rates into the stratosphere. But more importantly: so what if it did?

The immediate response is usually that middle class families wouldn't be able to buy houses. But this isn't quite right. Higher mortgage rates mean buyers can't spend as much on houses. But that means the demand curve would shift down and housing prices would come down; people would still need to move, they would still need to sell their houses, and the market would clear at a lower price level.

The market would also clear at a lower quantity, which means that over time the homeownership rate could go down. But this isn't as big a problem as it sounds. It's not like a consumer product market where lower quantity means less stuff. We'll still have the houses we have; they're not being destroyed. In fact, the current problem with the housing market is that we have too much housing stock for the number of households in the country (a point often made by [Calculated Risk](#)). Since housing at the margin can shift between homeownership and rental, whether a housing unit is used for one or the other doesn't matter from the standpoint of total production. If we want to soak up the glut of housing, we need new household formation (e.g., people moving out of their parents' houses). That is more likely to occur if the price of housing comes down. And only when the glut is soaked up will there be a reason for developers to build more.

Instead, one major effect of higher mortgage rates would be distributional: lower housing prices would hurt people who own houses (like me) and help people who don't. In general, this means hurting the rich and helping the less rich, and that sounds like a good thing to me from a simplistic Rawlsian perspective. But that's probably the main reason why our government has spent so much effort subsidizing mortgages and propping up the price of houses.

Then there's the wealth effect, which is fictional on the one hand but unfortunately real on the other. If you have \$100,000 in cash and a \$300,000 house, and tomorrow the value of your house falls to \$250,000 because all housing prices have fallen, you are exactly as rich as you were the day before for most practical purposes, assuming you still want to live in a house. You still have \$100,000 and one house. (There are exceptions, like if you plan to move someplace where houses are cheaper, in which case you will end up slightly worse off.) But unfortunately, you feel \$50,000 poorer, and that may crimp your consumption, hurting the economy. So if we're going to move to a world where the government doesn't suppress mortgage rates, we'll have to do it gradually.

So here's my not-very-thought-through proposal: Fannie and Freddie should continue doing what they are doing, as wards of the federal government. But every year, for each \$1 in assets that get paid off, they should only invest \$0.50 in new mortgages (the rest should reduce net debt). So gradually, over the next 15-20 years, their balance sheets should shrink to small fractions of what they are today, and then they should be shut down as borrowing and investing institutions. As I said above, I think it's possible and perhaps preferable to keep them in the role of defining and verifying conforming loan standards so that investors have some confidence in securities backed by those mortgages.

Yes, this would be a big experiment. But we've had a big experiment in subsidizing homeownership, and I'd say it hasn't worked out too well.

Now, to reassure regular readers of this blog, I'm not against subsidized mortgages because I'm against government subsidies in principle. I just think government subsidies should be saved for things that are worth subsidizing — like fruits and vegetables, for example. I should add that I'm no expert on Fannie and Freddie and I'm willing to be talked out of this position. But it seems to make sense to me.

\* Actually, there's a third kind of risk: prepayment risk. If interest rates go down, borrowers will refinance and pay off their mortgages. As a lender, you still get your principal back, but now you have to reinvest it at a lower interest rate. But Fannie and Freddie didn't do anything about prepayment risk anyway — that was still the principal risk faced by investors in mortgage-backed securities.

\*\* In fact, for the most part, Fannie and Freddie don't buy and hold the mortgages outright. They create mortgage pools that issue mortgage-backed securities that have a Fannie or Freddie guarantee. At the end of 2009 the government-sponsored enterprises had \$700 billion in home mortgages, while the pools had \$5.3 trillion in mortgages, according to the Fed's [Flow of Funds](#) report. Since the beginning of 2010, most of those pools are now consolidated on the Fannie/Freddie balance sheets, presumably because they are still on the hook for losses.

\*\*\* The originate-and-hold model did run into problems in the 1970s, but that was primarily because of volatile interest rates, not because of credit risk. Interest rate risk can now be hedged

using interest rate swaps, which weren't invented until 1980.

\*\*\*\* In 1960, life insurance companies held \$42 billion in mortgages.

**Update:** [Arnold Kling](#) caught a mistake above. Originally I said “That bank might just hedge the interest rate risk with interest rate swaps and hold onto the credit risk. This is what banks did during the postwar boom.” I meant to say that banks used to hold onto the credit risk, not that they used interest rate swaps. I know that interest rate swaps didn't exist back then (that's a point made elsewhere in the post). My point was that banks used to hold onto both interest rate and credit risk, and that model broke down because of the interest rate side, not the credit side. And on the interest rate side, you can use swaps today. Now, maybe there aren't enough people who want to take the other side of that swap, but there are plenty of pension funds and life insurance companies who need thirty-year assets.