Will The Real Geithner Plan Please Stand Up?

from The Baseline Scenario by Simon Johnson

With all the material and moral support for U.S. mega-financial institutions currently on the table, why are bank holding company credit default swap (CDS) spreads at new highs? (For more on how and why you might want to think about CDS spreads, we have a basic guide.)
The most plausible explanation is that creditors - unlike equity investors - are spooked by the new resolution authority that is now sought by Treasury and the Fed. This would, after all, allow the government to manage something akin to (but potentially better than, from a social perspective) a bankruptcy process for our largest financial institutions.

These creditors are right to be worried; the authority, if granted, would almost certainly be pressed by events (and creditors’ self-fulfilling runs) into use.

But, if handled right, this authority can help solve the financial mess at minimal cost to the taxpayer (although there are no magic bullets or easy exits at this stage). The key - as always in any major crisis - is decisive action. Over on wjs.com this morning, Peter Boone and I outline one way forward.

By Simon Johnson
Mar 30, 2009 7:52 AM

The G20 Communique: A Viewer’s Guide

from The Baseline Scenario by Simon Johnson

The draft G20 communique, as published on the FT’s website, is not encouraging. To be sure, there are humorous moments, such as:

each of us commits to candid, even-handed, and independent IMF surveillance of our economies and financial sectors, of the impact of our policies on others, and of risks facing the global economy;

Major countries have never allowed this and never will, despite a long tradition of such statements (e.g., ask about whether Gordon Brown welcomed frank assessments of the UK economy during the time he was chair of a ministerial committee that oversees the IMF). Asserting something blandly in a communique does not make it true, but it does - amazingly - often convince much of the media to applaud politely. Watching the spinmeisters at work is always entertaining although, under these circumstances, also more than a little scary.

On the real substance, the G20 punts on most of the big issues - as predicted, the language on monetary policy and fiscal policy is completely vacuous (paragraphs 3 and 4; the Europeans won big and the US lost on these issues), and the “regulatory reform” initiative amounts to building more ornate structures (we’re to get a new Financial Stability Board?!?) on the same weak foundations that got us into trouble. There is simply nothing substantive here that would not have happened without the G20 process; under current dire circumstances, window dressing is not a good reason to hold a summit.

Only three interesting points are apparently still open for discussion, all about some dimension of the IMF. First, how much additional funding will the IMF get (paragraph 6)? The debate is apparently still somewhere between an additional $250bn and $750bn. This is the most interesting headline number to watch for. If it’s only $250bn, that’s disappointing, and if they can’t give an exact predicted number (i.e., they fudge the blank currently in the communique), that’s a disaster.

Second, what is the form of increased funding for the IMF? Paragraph 6 mentions borrowing in the market and paragraph 8 mentions a general SDR allocation (this is essentially an increase in reserves for countries; stronger countries could lend these to weaker countries and it could make
a difference within Europe). Both could be significant departures from past practice, if done at scale. Keeping this language in the communique would be good (and, of course, you leak a communique in order to make it harder to take them out...); large specific numbers would be better.

Third, what will be the extent of financial support for the IMF from **emerging markets with deep pockets** (link is to a NYT article framing the issue this morning)? We will see that in their contributions to the expanded New Arrangements to Borrow (paragraph 6). If the summit ends without firm commitments from China and Saudi Arabia (again, it’s all about seeing exact numbers), that is not good.

The big test of the summit’s IMF-centric approach will be whether the IMF can get its increased resources lent out (paragraph 7), particularly on newly generous terms “for countries with strong policies”? This will happen quickly if it happens at all, and the body language of emerging markets at the G20 - including whether Mexico, Brazil and others sign up for the new facility - should give us early indications.

The failure to mention the need to restore IMF staffing resources in the communique is, of course, between incomprehensible and irresponsible - **details here** (the IMF needs more people; the ill-timed budget cuts of 2008 must be undone as a matter of international priority). If the G20 wants its IMF-centric approach to be taken seriously, heads of government need to focus on how the job gets done, not just on slogans and wishful thinking.

The least surprising news is of course in paragraph 24 - the G20 will meet again before the end of the year. Once started, this kind of summiteering tends to go on for a long while.

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Mar 30, 2009 3:14 AM

**Obama Against The Odds**

from **The Baseline Scenario** by Simon Johnson

The G20 summit is headed for disaster. The Europeans have circled their wagons and determined that no sensible policy proposal shall pass. The background briefings indicate
(a) the US has given up on global fiscal stimulus (”declare victory and retreat” springs to mind),
(b) and the manifest failures of financial regulators will be addressed through, well, a manifest of failed regulators.

None of the important issues are on the table or even allowed in the building: changing the European Central Bank’s monetary policy, persuading European politicians to acknowledge they were and largely still are asleep at the wheel, and the future of big banks everywhere.

The summit will begin with dinner on April Fool’s Day. The organizers have clearly not thought much about the symbolism.

Yet, there is still a slim chance that President Obama can snatch victory from the teeth of West Europeans. He has to stare them down on substance, pushing hard the line that the US is doing everything it can, while Europe is largely standing idly by.

It’s an uphill struggle to force Europe to save itself, but with the discussion around the IMF, the President has a chance to move things in the right direction — and to back Secretary Geithner with actions as well as words (for more on this, see TNR online from March 28). The Europeans do not respond to sweet talk; only tough pressure will bring results.

As I suggest in my latest piece (this morning) in The New Republic online, the Europeans have left themselves open to effective confrontation on a key point; if the President can seize the day and really push the Europeans hard on this dimension - and tell me if you see other ways he can make European complacency painfully evident - we might actually make some progress.

By Simon Johnson

Mar 29, 2009 7:16 PM

Structured Finance for Beginners

from The Baseline Scenario by James Kwak

For a complete list of Beginners posts, see Financial Crisis for Beginners.
This is more of an advanced beginners topic - I already covered CDOs (collateralized debt obligations) in my first Beginners article - but I imagine that most of our readers are already familiar with structured products. At least, many people know that first a bunch of securities are pooled together, and then they are “sliced and diced,” in the common media parlance I find incredibly annoying. But Joshua Coval, Jakub Jurek, and Erik Stafford have a new paper, “The Economics of Structured Finance,” which does a brilliantly clear job of describing what these securities are and why they were so widely misunderstood, with the results we all know.

The paper is 27 pages long, not counting references, tables, and figures, and if you are comfortable with probabilities and follow it carefully you can understand everything in it. I will provide a summary to whet your appetite. I am not going to use numerical examples because the examples they use throughout their paper are so good.

The key to CDOs is that they could be used to manufacture AAA-rated securities out of underlying securities (like mortgages) that were not even close to AAA. (“AAA” is a bond rating, meaning that the security in question had about a 0.02% chance of defaulting in a given year.) This is well known. But although these new, synthetic securities had expected default rates comparable to traditional AAA-rated securities, they had other properties that were unlike their traditional brethren, having to do with (a) correlations between the underlying assets and (b) sensitivity to underlying default rates. (a) is the probability that, if one mortgage inside a pool defaults, the other mortgages will also default; (b) is the degree to which small changes in those default rates can affect the expected value of the manufactured AAA securities. This meant that these CDOs were much more sensitive both to errors in estimating their characteristics, and to macroeconomic changes, than most people realized.

If you didn’t follow that I’ll go over it again more slowly.

In a simple, “pass-through” securitization, each investor in the pool of mortgages has an equal claim to the mortgage payments. Therefore, the expected loss for each security is exactly the same as the average default rate of the mortgages.

In a CDO, the investors have unequal claims. By creating some junior tranches (“tranche” is French for “slice,” in case you were wondering) that absorb the first losses, you create a large senior tranche that is buffered and suffers no losses until all of the junior tranches are completely wiped out. This is why the senior tranche can get a AAA rating; the estimated chances are pretty low that enough people will default to wipe out the junior tranches. In a CDO-squared, you take some of the junior tranches of ordinary CDOs, pool those, and then create tranches out of that pool. The amazing thing is that you can then create not only a senior tranche but a mezzanine (middle) tranche of your CDO-squared that has the expected default rate of a traditional AAA bond, even though it is made out of junior tranches. (There are very clear examples of all of this in the paper.)

However, this only works well if the default probabilities of the underlying mortgages are not highly correlated. Assume in an extreme case that defaults among the underlying mortgages are perfectly correlated: either none default or they all default. In this cases, the tranches do nothing
for you: if all the mortgages default, then the senior tranche gets wiped out along with the junior tranches.

Furthermore, the performance of AAA-rated tranches is highly sensitive to the default rates of the underlying mortgages. Conceptually, this happens because the amount of protection provided by the junior tranches is not that much bigger than the expected default rate; so if the actual default rate is just a little higher than expected, a much larger proportion of the protection will get eaten up. In the example in the paper, an increase in defaults from 5% to 7.5% can knock a AAA-rated tranche of the CDO-squared down to a BBB- rating.

The conclusion is probably apparent to many readers at this point. The underlying mortgages were more highly correlated than people thought, both because they often came from the same types of developments in the same regions (California, Nevada, Florida), but also because everything in the economy became highly correlated. And as the economy got worse, default rates climbed higher than estimated based on historical data, because all the historical data came from a period when housing prices only went up. While this would only have a “linear” impact on a simple pass-through securitization (double the defaults, double the losses), it had a “non-linear” impact on AAA tranches of CDOs, and especially of CDOs-squared.

Finally, there is one more misunderstood characteristic of CDOs. Securities with the same expected payoffs, and hence the same rating, can have different characteristics. In particular, they can differ in their degree of correlation with the rest of the economy. The authors cite catastrophe bonds (which default only, for example, if a hurricane hits South Florida) as securities that are uncorrelated with the economy. Because of their lack of correlation, they are more desirable than other securities with the same rating, and hence have lower yields (higher prices). Senior tranches of CDOs are just the opposite: they only go bad if the economy as a whole goes bad; that is, they are highly exposed to systemic risk, which almost by definition is difficult to quantify. Because of this high degree of correlation, investors should have demanded higher yields (lower prices). But because investors by and large thought that all AAA securities were comparable, they didn’t demand high enough yields, and the issuers (investment banks) made the difference.

The bottom line is that all AAA securities are not created equal - even if they have the same estimated probabilities of default. And treating AAA tranches of CDOs and CDOs-squared as if they were AAA corporate bonds played an important role in the growth of the structured finance market and, as a result, the overall asset bubble that is collapsing around us.

**Update:** A reader points out that CDOs generally do not contain mortgages, but instead already contain subordinated (not senior) tranches of mortgage-backed securities or of other CDOs. And the mortgages inside those mortgage-backed securities are often subprime. Because these tranches are themselves unique, it is even harder to project the cash flows coming into a CDO. A mortgage-backed security backed by a pool of plain vanilla mortgages, by contrast, would be relatively easier to value and less subject to price fluctuations.

*By James Kwak*
My colleague Ilya Podolyako is back with a comment on the Geither Plan to buy toxic assets, as well as an update to his previous post about the constitutionality of government takeovers of private property. He discusses in particular the possibility (also suggested by one of our readers) that the government could “seize” toxic assets and pay “just compensation,” even in the absence of a bankruptcy or a takeover. Ilya is a 3rd-year student at the Yale Law School and, among other things, an executive editor of the Yale Journal on Regulation. The post below is by Ilya.

PPIP for Legacy Loans = Free Put Options for Banks

I finally got a chance to read through the PPIP plan in detail. I noticed one curious point: under the program as announced, auctions for the legacy loans do not appear to be binding on the contributing entity.

The Process for Purchasing Assets Through The Legacy Loans Program: Purchasing assets in the Legacy Loans Program will occur through the following process:

... Pools Are Auctioned Off to the Highest Bidder: The FDIC will conduct an auction for these pools of loans. The highest bidder will have access to the Public-Private Investment Program to fund 50 percent of the equity requirement of their purchase.

Financing Is Provided Through FDIC Guarantee: If the seller accepts the purchase price, the buyer would receive financing by issuing debt guaranteed by the FDIC. The FDIC-guaranteed debt would be collateralized by the purchased assets and the FDIC would receive a fee in return for its guarantee.
This is quite odd, since, if I read it correctly, it turns the entirety of the program into a put option for participating banks. That is, they could identify certain assets, put them up for auction seemingly risk-free, check the result, and reject anything below their internal valuation without any further capital contribution.

The structure, which seems to be confirmed by the term sheet ("Once a bid(s) is selected, the Participant Bank will have the option of accepting or rejecting the bid within a pre-established timeframe"), amplifies the lemons problem that Simon and James mention in their LA Times op-ed. If the plan revolved around binding auctions, a temporary market for the toxic assets could develop while investors make government-guaranteed “probing” bets on the precise toxicity of the assets for sale. If banks wanted the auctions to recur instead of being a one-time event (perhaps to sell a larger or more diverse set of loans), they might mix in some good assets with the bad ones. This move would assuage concerned investors and probably make it easier for the banks to get approval from their regulators for the particular sale. Investors who were smart/lucky enough to win the good assets with bids below their “worth” to the bank on a medium-term basis would then get to profit from their decision. Other buyers would want to follow suit, at least until the point in time when they would expect a bank to cash out on any previously established confidence with a large offer of only toxic securities that would earn a lot of money even in the absence of future auctions.

By contrast, if banks can selectively reject bids, they could offer an enticing mix of good and bad assets (say, 50/50) and then accept only the ones that grossly overpay for the bad ones. That is, they would get full power to exclude intelligent, accurate price setters from the auction process, undermining the efficacy of the program to an even greater extent than adverse selection would in a committed-sale context. Of course, it is not clear whether the current setup is objectively worse than the repeated-game lure-and-hook scenario, but the question is worth considering.

Updates on the Constitutionality Issue and the “Brute Force” Plan B

I thought I would provide some clarification on how I see the Fifth Amendment applying to the current stage of the economic crisis.

First, contrary to what some have suggested, the constitutionality of government policy is not irrelevant. As long as the courts are open, private parties can file suit either to stop prohibited actions from going forward, or, in a less extreme scenario, to get money damages. True, courts often dodge heated constitutional issues, but in the 1950’s, they saw it fit to prohibit the nationalization of steel mills during a time of war, so the Fifth Amendment is still a force to be reckoned with.

Second, I am suggesting that sudden regulation of previously unregulated entities would constitute a taking, not that all new regulation does. Retroactivity is key here: the Fifth Amendment protects vested interests from being nullified or diminished by new laws, but does not prevent Congress from forcing new entrants to comply with a fresh framework. Furthermore, cases on the topic make it clear that when investors knew ex ante that they were buying into a highly regulated business, new rules would not trigger constitutional scrutiny unless they explicitly contradicted previous administrative promises. For present purposes, this means that
even if Congress passes a bill allowing Treasury to seize hedge funds or nationalize large conglomerates at will, the Department will still have to provide “just compensation” to previous owners.

Of course, the extent of this compensation matters a great deal for evaluating the viability of particular administrative actions. As I mentioned in the previous entry, constitutional law clearly includes contractual rights to cash flows in the definition of property. Stock and subordinated bonds fall into this category. Furthermore, there seems to be judicial consensus that, for constitutional purposes, equity has value even when the operating business appears to be insolvent, provided that this business is not actually in bankruptcy proceedings. The approach makes sense: in the face of uncertainty, both junior debt and common stock constitute a call option, and call options have value even if they are deep out of the money. For example, while Citigroup may well be unable to function without government aid right this second, its common stock is trading at $2.62 because of the possibility that the company will survive the crisis intact and generate dividends/appreciate in value in the future. If the government were to nationalize Citi and push the value of the stock to 0 by decree, it would potentially be on the hook for the entire $14 billion market cap.

The application of the takings doctrine to debt is more complicated. Suppose the government takes over Citi and says it will pay only 30 cents on the dollar for its junior unsecured liabilities, which matches the market price for these bonds. The Supreme Court has wavered on the extent of just compensation required for this 70% haircut. The traditional test for regulatory takings in *Penn Central* emphasizes diminution of value as the takings metric, and one could argue that paying market price for the assets does not diminish their value. On the other hand, unexpected termination of the option on future cash flows does foreclose the valuable possibility of getting more money back. I really don’t know which way a court would come out here. I do know, however, that a failure to give the debtholders a chance to argue for a higher price for their assets (either in court or some special tribunal) would probably incur judicial wrath for breaching either the takings and due process clauses of the Fifth Amendment or the Seventh Amendment guarantee that civil controversies over $20 will be settled by juries.

Again, if investors in AIG, Citigroup, SAC Capital Advisors, or General Motors knew that this kind of executive intervention was possible when they put up their money, the story would be completely different. It is the sudden imposition of new, costly rules that is the problem. This temporal element highlights the difference between nationalization and various versions of bankruptcy: even if Article I, Section 8 of the Constitution did not explicitly authorize a uniform bankruptcy code, it could pass muster under the Takings Clause merely because some version of the judicial power to settle claims on insolvent debtors was in place long before any current investors were born. That is definitely not true of the power to summarily seize any institution that poses systemic risk to the financial system, as evidenced by the fact that Geithner and Bernanke made their plea to Congress this week in the first place.*

There is an upside to all of this - the “brute force Plan B.” If the Public-Private Investment Partnership fails due to a lack of participation by banks, investors, or both, the government could just file suit in a federal district court to take control over any toxic assets it wants. The fact that the judicial branch would oversee the action would preempt any due process or Seventh Amendment guarantee.
Amendment challenges. Banks would come in as defendants in the action. Treasury would still be on the hook for “just compensation,” but in the current political climate, juries are likely to be pretty stingy with taxpayer money. Indeed, banks may prefer a quick hand-over of the assets to actually litigating the claim. For the sake of expediency, the government could also attempt to seize the assets first in exchange for their “market value” and litigate any factual questions later. I am not persuaded that this course of action would actually be any faster, since banks could ask a court for a temporary restraining order to block the action. This would move the policy back to litigation square one, but now the executive branch would look like it was avoiding judicial scrutiny instead of trying to maximally honor the constitution in difficult financial times. All things being equal, it is better to get to the judges first.

Thanks to Jesse Townsend for feedback on the constitutional analysis above.

By Ilya Podolyako; posted by James Kwak

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Mar 28, 2009 11:48 PM

Does Size Matter?

from The Baseline Scenario by James Kwak

Simon argued in the Atlantic article, and I argued in “Frog and Toad” and “Big and Small”, that the best way to regulate the financial sector is to limit the size of individual institutions. In the interests of providing a contrasting point of view, I want to point out that Kevin Drum thinks that small banks can do just as much damage as big banks:

I think crude bank size is a red herring for our current financial collapse. Small banks can become overleveraged just as easily as big ones, hedge funds pay higher salaries than Wall Street behemoths, the interconnectedness of the global financial sector is a bigger cause of systemic worries than size alone, and credit expansions spiral out of control largely due to lack of political will, not because Citigroup is large and clumsy. Those are the things we should be focused on.

Therefore, Drum favors systemic oversight and regulation (which I agree would also be good). Besides the first article cited above, he continues the argument here.
Is The G20 Summit Worth Holding?

from The Baseline Scenario by Simon Johnson

We know already much of what the G20 will produce: a communique that looks very much like the last one (dubious reassurances about the great progress being made along vague dimensions), no progress on fiscal stimulus (as we have been projecting for some time), and promises to clamp down on regulation for hedge funds and the like (fine, but how relevant is this to either what caused the crisis or what can sustain a recovery?)

Almost all the important issues are kept off the table by anachronistic diplomatic niceties: monetary policy around the world, Europe’s impending crisis, and how to escape the overweening power of major banks in almost all industrial countries. The G20 summit has substantially failed even before it begins.

There is, however, one topic worthy of debate that is still on the agenda - the IMF. We need the IMF to have enough resources to help out when small and not-so-small countries get into trouble. Feel free to imagine IMF-less futures, but when the chips are down - as in Europe right now - to whom else can countries turn for money, advice, and the keys to international support? When they go to the EU, the Germans, the Swedes, or any other regional power, they are told bluntly: bring in the Fund.

The G20 therefore has to address the current low level of funding at the Fund - as the world economy and financial flows grew, no one bothered to increase the resources available under global financial emergency conditions. And here there is great tension - as I discuss in a piece at the New Republic online, the Europeans are lowballing (for no good reason), the emerging markets are standing idly by, and only President Obama could potentially rise to the occasion. But with so much else going on in the US financial sector and around the world, can he focus his persuasive powers sufficiently to win the day - particularly on and around a topic as dry as the IMF?
Or will the key issues get punt to the G7/IMF spring meetings at the end of April? In international economic diplomacy, there is always another summit and another crack at meaningless communique drafting just around the corner.

*By Simon Johnson*

Mar 27, 2009 11:37 AM

**Big and Small**

from *The Baseline Scenario* by James Kwak

Yesterday, Treasury Secretary Geithner presented an outline of his approach to regulating the financial system. The four pillars of that approach seem to be:

1. Increased power and regulatory centralization to deal with the problem of systemic risk
2. Increased protections for consumers and investors buying financial products
3. Closing regulatory gaps by shifting that organizes regulation based on financial functions, not types of financial institutions
4. International coordination among regulators

This all sounds good to me, and an improvement over where we are today. But reading Geithner’s discussion of systemic risk - the topic he focused on yesterday - I kept thinking it had been too long since he read *Frog and Toad* to his children.

The section on systemic risk reads like this (emphasis added, feel free to skim):

To ensure appropriate focus and accountability for financial stability we need to establish a single entity with responsibility for consolidated supervision of systemically important firms and for systemically important payment and settlement systems and activities.
we must create higher standards for all systemically important financial firms regardless of whether they own a depository institution, to account for the risk that the distress or failure of such a firm could impose on the financial system and the economy. We will work with Congress to enact legislation that defines the characteristics of covered firms, sets objectives and principles for their oversight, and assigns responsibility for regulating these firms.

In identifying systemically important firms, we believe that the characteristics to be considered should include: the financial system’s interdependence with the firm, the firm’s size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding, and the importance of the firm as a source of credit for households, businesses, and governments and as a source of liquidity for the financial system.

Given the existence of “systemically important firms,” I agree they need careful regulation. But why does Geithner assume that they have to exist at all?

There are a few main things that made companies like AIG and Citigroup systematically important. One was interconnectedness: they did business with lots of counterparties. One was complexity: when push came to shove, the regulators were not able to assess the potential damage a failure could cause, and therefore erred on the side of bailing them out. But the big one was size, and this is why we call it Too Big To Fail. The companies in question were so big, and had so many liabilities, that they could cause a lot of damage if they suddenly defaulted on those liabilities.

Interconnectedness is not going to go away. Complexity may not go away completely, but increased supervision could give regulators a better grasp on complexity. For example, all firms could be required to provide detailed information about their positions to regulators, in a standardized format, so that it could be imported into aggregate computer models; data about positions would be kept only by the regulator and not made public. Complexity could also be reduced by limiting the number of businesses an institution is allowed to engage in (like under Glass-Steagall, but updated for today’s world). But size can definitely go away, simply by setting a cap on the volume of assets any institution is allowed to hold (and doing something about off-balance sheet entities). And if a highly interconnected, highly complex but small financial institution fails, the system as a whole would be fine.

What would such a world look like? There would be a lot of small- and medium-sized banks that collected deposits and lent money to households and businesses. There would be brokerage and asset management firms that you used to invest your savings. There would be hedge funds and private equity firms that rich people and other institutional investors used to invest their money. There would be investment banks that helped companies issue equity and debt securities. There would be boutique firms that did research and other boutiques that M&A advising. For any financial service anyone wanted, there would be a company that provided that service; it just wouldn’t necessarily provide every other service, and it wouldn’t have $2 trillion in assets. It would look something like the 1970s.

What’s wrong with this picture? Some people would argue that it would limit financial innovation. But there is no correlation (or a negative one) between the size of a firm and its
degree of innovation. Nor do you need to operate a financial supermarket to innovate: mortgage-backed securities were pioneered by Salomon Brothers, an investment bank under the old definition. Finally, perhaps we could use a little less innovation.

Some would argue that costs would be higher, because smaller firms would be less able to capture economies of scale and scope. First, casual empiricism debunks this theory immediately. When I got my mortgage on my house, I got a much lower rate at a small community bank (which holds onto its mortgages rather than reselling them) than at any national bank. National banks also typically offer the lowest rates to savings customers, except when they are about to fail and desperately need cash from depositors. Second, even if this were the case, perhaps slightly higher costs are a price worth paying for reduced systemic risk.

Basically, this is the issue that Ronald Coase discussed in “The Nature of the Firm” (Wikipedia summary; paper). A firm’s optimal size is reached when the transaction costs of doing business in the market equal the administrative costs of managing the firm; the bigger the firm, the higher the administrative costs. Clearly some financial institutions reached a level of scale and complexity where they simply could not even understand what they were doing, let alone manage their risks appropriately; they were too big, looked at just from their own perspective (and excluding the implicit Too Big To Fail subsidy). To this equation, we now need to add the social costs (negative externalities) of being Too Big To Fail: moral hazard, socialized losses, and so on.

To some people, the idea of size caps will seem anti-capitalist (or even un-American). However, that viewpoint is based on a misunderstanding of what the modern large corporation actually looks like. In the United States, supposedly the most dynamic capitalist economy in the world, our corporations are run almost exclusively as giant bureaucracies with a rigidly hierarchical decision-making structure. When I was in the business world, I saw several of these entities from the inside or up close, and they are identical: there’s barely a trace of the free market to be found. Even in the technology industry, the biggest companies, like Cisco and Oracle, expand by buying innovation from startup companies where the innovating actually happens. (Some large technology companies expand by copying innovations made by startup companies, but that’s another subject.)

Geithner’s testimony yesterday did contain at least one important insight:

In general, the design and degree of conservatism of the prudential requirements applicable to such firms should take into account the inherent inability of regulators to predict future outcomes.

When you are designing regulation, you have to bear in mind that the world will change. But this is another reason why simpler is better, and the simplest solution is simply to prevent firms from becoming Too Big To Fail in the first place. First, you have to expect that no matter how clever your regulatory scheme, some firms will be even more clever in finding ways to evade the system and blow themselves up. You are far better off if they are small when they blow up than if they are big.
Second, one of the “future outcomes” you have to protect against is that the firms being regulated will try to change the regulations. So one prerequisite to a successful regulatory structure is limiting the political power of the firms being regulated. This is, ultimately, the most important reason why smaller is better.

**Update:** Paul Krugman says something similar in his *op-ed today*:

America emerged from the Great Depression with a tightly regulated banking system, which made finance a staid, even boring business. Banks attracted depositors by providing convenient branch locations and maybe a free toaster or two; they used the money thus attracted to make loans, and that was that.

And the financial system wasn’t just boring. It was also, by today’s standards, small. Even during the “go-go years,” the bull market of the 1960s, finance and insurance together accounted for less than 4 percent of G.D.P. The relative unimportance of finance was reflected in the list of stocks making up the Dow Jones Industrial Average, which until 1982 contained not a single financial company.

It all sounds primitive by today’s standards. Yet that boring, primitive financial system serviced an economy that doubled living standards over the course of a generation.

**Update 2:** [Calculated Risk](http://www.calculatedriskblog.com) has this gem which I meant to include in my original post but forgot:

Imagine if the Federal Reserve had been the “systemic-risk regulator” during the bubble.

According to Greenspan in 2005 “we don’t perceive that there is a national bubble”, just “a little froth”, and even in March 2007 Bernanke said “the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained”.

How would a systemic-risk regulator help if they miss the problem?

So it’s good to have a systemic risk regulator, but it’s best to minimize the chances of systemic risk getting big in the first place.

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Mar 27, 2009 5:56 AM

**Payback Time**
Once upon a time there was a president named George. He liked to do things his own way, which annoyed some of his “friends” in Europe. But then a new president named Barack was elected, who not only promised to be nicer to his friends, but was actually very popular in most parts of the world. And the people of the world thought we would see a new era of international cooperation, at least between the U.S. and Europe.

Not so much.

On this side of the Atlantic, the Obama administration and the Fed have been working night and day in an attempt to turn around the economy: Fed funds rate reduced to zero, $800 billion stimulus package, new plan to aid struggling homeowners, new plan for buying toxic assets, new budget, decision by the Fed to buy long-term Treasury bonds, new domestic regulatory framework outlined this week, etc. We’ve been plenty critical of various aspects of the U.S. response, but at least they’re trying.

(Continental) Europe, by contrast, has decided they’ve done enough and it’s time to sit back and watch.

First, in an interview for Monday’s Wall Street Journal (no-subscription-required summary here), Jean-Claude Trichet, head of the European Central Bank, said that no new measures are needed to combat the global economic crisis. Then Mirek Topolanek, the prime minister of the Czech Republic and the president (in this rotation) of the European Union called the U.S. emphasis on fiscal stimulus “the way to hell.” And all of this is coming in the week leading up to the next G20 summit. What happened to diplomacy?

While it is relatively easy to write off a prime minister whose government collapsed on Tuesday night, there is a very real divide between the United States and, in particular, Germany, the heavyweight in the European economy. And it’s very clear that the Germans (and the French) do not want to spend more money, increase their budget deficits, or do anything except talk about international financial regulation.

I think there are three possible reasons for this attitude.

1. The Germans believe that the economy will recover on its own from this point. Given that not even the optimists in the Treasury Department believe this, I don’t see how this could be the case.

2. They are so afraid of any risk of inflation that they would rather suffer through an extended recession and high unemployment. This could be possible, although misguided,
especially since Germany is already in worse shape than the U.S., with its economy expected to shrink by 3.8% this year (vs. 2.5% for the U.S.).

3. They realize that their economy is driven by exports, and therefore they are planning to free ride off of the U.S. stimulus package. In this scenario, Germany gets to contain its national debt and minimize the risk of inflation, while letting other countries turn the global economy around.

Now, we’re not blameless here, what with our “Buy American” provision in the fiscal stimulus. But at least our government isn’t closing its eyes and assuming the problem will go away.

Mar 26, 2009 5:52 PM

**What the IMF Would Tell the United States, If It Could**

from *The Baseline Scenario* by James Kwak

From 1945 until around 1980, the financial sector was one industry among many in the United States. Then something happened.
People in finance started making more money,* jobs in finance became more desirable, financial institutions became more influential, and the linkages between the financial sector and the political establishment became stronger. At the same time that our financial sector became more leveraged and more risky, it also became more powerful. The result was a confluence of interests between Wall Street and Washington - one more normally found behind the scenes of emerging market crises, the kind the IMF is called on to resolve.

Simon and I tell this story - and the story of what happened next - in “The Quiet Coup,” an article in the May issue of The Atlantic. (Many thanks to The Atlantic for putting the online copy up as early as they did.) The working title of the article was, “What the IMF Would Tell the United States, If It Could.” Enjoy.

* The data in that chart are from Table 6.6 of the National Income and Product Accounts tables available from the Bureau of Economic Analysis.
Update: Henry Seggerman recently sent us an article he wrote in 2007, comparing the Korean crisis of 2007 to the then-current situation in the United States. He discusses not only the economic similarities, but also some of the political ones.

Update 2: A reader sent us an article about Mark Patterson, formerly Goldman’s chief lobbyist and now Tim Geithner’s chief of staff. Unfortunately, the article was published too late for us to use any of it in our Atlantic article.

By James Kwak

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Mar 26, 2009 7:23 AM

Watch Sternly

from The Baseline Scenario by Simon Johnson

Writing in the FT yesterday, Nick Stern made the case for a new international organization to monitor global risks. Drawing on a decade of dealing with governments as board members of such organizations, he is blunt - keep them out of day-to-day oversight, by giving the institution an endowment and a leader appointed for 7 years without possible recall.

Lord Stern is right to be cynical about governments in this context, but his solution feels a bit too much mid-20th century. If the organization got off the ground, governments would compete madly to appoint the leader - trying for someone over whom they have a hold (it has happened). And if the organization really were independent, who would pony up the endowment or be comfortable with the (low) implied level of democratic accountability - it’s hard to see Senate Foreign Relations or Banking (both of which have jurisdiction over the IMF) getting excited about this arrangement. Without the US there can be no meaningful deal.

And, thinking more about 21st century formats, don’t we already have - albeit in still emergent form - exactly what Professor Stern wants?
I’m not suggesting that today’s blogs do a great job addressing the need for early and clear warning about emerging global problems. But the broader debate on and around the Internet is definitely moving us in the right direction.

If you want to know what is going on and why, you have a range of sources - some more news analysis, others more commentary - readily available. The depth of coverage improves every day. There are technical explanations (and these increasingly confront officials on the details), as well as broader expositions. Readers’ comments are an essential advantage, both as an input into the debate and as feedback on what makes sense or has been explained well or is seriously off-track.

The exact structure that will emerge remains unclear, and I’m not suggesting that it will completely supplant more traditional national or international economic organizations and their reports. But, in terms of early and frank warnings, I would look much more to the blogosphere than to anything officially backed by the G20 - you’ll never get the same level of directness in anything that involves governments.

I would also suggest that President Obama is likely the last US President who will say something along the lines of, “we don’t spend a lot of time looking at blogs.”

Mar 26, 2009 1:04 AM

Frog, Toad, Cookies, and Financial Regulation

from The Baseline Scenario by James Kwak

My two-year-old daughter loves Frog and Toad.

There is a Frog and Toad story called “Cookies.” It is the only Frog and Toad story I remember from my childhood. Toad bakes some cookies and takes them to Frog’s house. They are very good. Frog and Toad eat many cookies, one after another. They try very hard to stop eating cookies, but as long as the cookies are in front of them, they cannot help themselves.
So Frog puts the cookies in a box. Toad points out that they can open the box. Frog ties some string around the box. Toad points out that they can cut the string. Frog gets a ladder and puts the box on a high shelf. Toad points out . . .

Finally Frog takes down the box, cuts the string, opens the box, and gives all the cookies to the birds.

“Read more, Daddy,” my daughter says.

“One moment, I have to tell all the nice people the moral to the story.”

On last Friday’s Planet Money, Alex Blumberg talked to Republican Congressman John Campbell (starting around 24:30), who happens to be on the House Financial Services Committee. According to Campbell, there are three broad regulatory designs under consideration:

1. Break up the banks and impose rules to keep them small (simple size caps).

2. Allow large banks, but impose stringent regulations on them.

3. Similar to 2: Allow large banks, but impose regulatory constraints that increase with size (for example, increasing capital adequacy requirements), so that at some point being large becomes unprofitable.

These may all seem like plausible solutions when you look only at economic considerations, but not when you consider political factors. The most fundamental problem is that as long as you have big banks, they can climb the ladder, take down the box, cut the string, open the box, and eat all the cookies. For example, when Citigroup merged with Travelers in 1998, there was this thing called the Glass-Steagall Act, which prohibited mergers between banks and insurance companies. Sandy Weill, chairman of Travelers, said at the time: “We are hopeful that over that time [two to five years] the legislation will change . . . We have had enough discussions [with the Fed] to believe this will not be a problem.” Sure enough, the legislation changed.

Options 2 and 3 allow banks to become big and then use their power to weaken the regulations. Frog should have put the box on the shelf, climbed down, and smashed the ladder. Yes, someday he might have built a new ladder, and no regulatory scheme can serve its intended purpose forever. But the simpler it is, and the weaker the parties who want to undermine it, the stronger it will be.
What’s Plan B?

from The Baseline Scenario by James Kwak

One of the determinants of how you feel about the Geithner Plan is what you think will happen if it fails. By “fails,” I mean that the buyers’ bids are lower than the sellers’ reserve prices, so the toxic assets don’t actually get sold.

Brad DeLong, for example, is moderately in favor of the plan, even though he thinks it is insufficient. In his words, “I think Obama has to demonstrate that he has exhausted all other options before he has a prayer of getting Voinovich to vote to close debate on a bank nationalization bill. Paul [Krugman] thinks that the longer Obama delays proposing bank nationalization the lower it’s chances become.” (”Voinovich” is DeLong’s hypothetical 60th senator, whose vote would be needed in the Senate.) In other words, DeLong thinks that if this plan fails, the administration will be more likely and able to go forward with nationalization.

Paul Krugman, by contrast, is strongly against the plan, first because he thinks it has no chance of succeeding, and second because he thinks there is no Plan B. “I’m afraid that this will be the administration’s only shot — that if the first bank plan is an abject failure, it won’t have the political capital for a second.”

I think the plan is likely to fail, or at least to be very insufficient, for reasons described elsewhere. I am also worried that the Obama administration has committed itself so strongly against taking over large banks that it cannot reverse course, at least not unless it sacrifices Geithner. So I expect Plan B to be more generous to the banks - which means it will have little chance of getting any money out of Congress (and the $700 billion will run out at some point). The increasingly friendly stance toward Wall Street also implies this course of events.

On the other hand, today’s reporting on what Bernanke and Geithner were actually asking for yesterday is a little bit promising. From The Wall Street Journal:

The bill, said Treasury, would cover financial firms that have the potential to severely disrupt the U.S. financial system. That would include bank holding companies and thrift holding companies as well as companies that control broker-dealers, insurance firms and futures commission merchants.

On my read of this passage (I haven’t seen an actual bill yet), the proposed legislation would enable regulators not only to supervise bank holding companies, which they can do today, but to take them over and wind them down just like the FDIC can do with depository institutions. If Treasury and the Fed have this power - and I think they should have it - it could improve their
negotiating position relative to the big banks. It could also indicate that the administration wants to have this power in its back pocket just in case it needs to use it. (Using the AIG scandal to get this power is a clever political move.) I still don’t think this is Plan B, but it could mean that they want all options open.

**Update:** More information on the proposed new bill in the [WSJ](http://www.wsj.com).

Treasury said the draft bill would enable the federal government to seize troubled bank- and thrift-holding companies as well as firms that control broker-dealers and futures commission merchants.

An Obama administration official confirmed that the legislative proposal would also give the government authority to shut down troubled hedge funds, which currently face minimal oversight. The government could potentially use the new “resolution authority” on any nonbank financial firm that is deemed to pose systemic risk, the official added.

*By James Kwak*

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Mar 25, 2009 1:03 PM

**Potential Constitutional Obstacles to Nationalization and the Economic Rescue Plan**

from [The Baseline Scenario](http://www.baselinescenario.com) by James Kwak

*The more aggressive the government’s responses to the economic crisis become, the more likely that they will end up in the courts. Changes in regulation can be interpreted as constraints on the ownership of property - especially by the people who own that property - and therefore such changes have occasionally ended up in the Supreme Court. The article below is by Ilya Podolyako, a third-year student at the Yale Law School and the co-chair (with me) of a reading group on law, economic policy, and the economic crisis.*

As the New York Times reported today, Geithner and Bernanke were on Capitol Hill to ask for greater power to wind down non-bank financial entities like AIG. During the hearing:
[Representative Barney] Frank said the different fates of Lehman Brothers and A.I.G. illustrate the need for options beyond the “all or nothing” approach. “One was the Lehman Brothers example, where they were allowed totally to fail and there was no help to any of the creditors,” Mr. Frank said. “The other is the A.I.G. example, where there was help for all of the creditors. Neither one is what we should be doing going forward.”

Geithner and Bernanke largely concurred. Basically, the key actors want to be able to apply a receivership/conservatorship-type system that currently covers members of the FDIC, Savings and Loan institutions, and Fannie/Freddie to any entity whose financial activity poses a systemic risk to the economy.

James has pointed out that proponents of nationalization for Citigroup and Bank of America have essentially the same thing in mind: have the government take over an entity, preserve the rights of depositors, and sort out which liabilities deserve payment and which do not. Baseline Scenario has consistently and persuasively argued that such an approach would be prudent. Indeed, it would avoid the awkward political fallout of the type that arose when AIG disclosed that $60+ billion worth of federal aid went directly to its various derivatives counterparties. The problem is, this policy might not be constitutional.

The last phrase of the Fifth Amendment to the U.S. Constitution, known as the takings clause, reads: “nor shall private property be taken for public use, without just compensation.” Its potential application to a significant chunk of the economic recovery programs is straightforward. A facial reading of the above text suggests the U.S. federal government (and state equivalents, similarly bound through the Fourteenth Amendment) cannot unilaterally restructure the contractual obligations of a given entity, summarily dismiss its outstanding debts, or even choose to pay some arbitrary fraction of these while waiving the rest. Curiously, however, there has been precious little commentary on just this point. Laurence H. Tribe, a professor at Harvard Law School, summarily dismissed the issue when evaluating the legality of a 90% tax on bonuses in his email to the Atlantic. Mayer, Morrison, and Piskorski gave it a bit more coverage in their mortgage modification proposal, but still seemed to be glossing over the main point by citing to a recent Supreme Court case that dismissed a very loose standard for takings jurisprudence without explicitly stating whether a taking took place.

Larry Tribe is more of an expert on constitutional law than I may ever be, but a closer look at the doctrine looks rather ominous, even if one presumes that, pursuant to the controversial Supreme Court decision in Kelo v. City of New London, 545 U.S. 469 (2005), any economic recovery program would pass the public use test. First, there is a consensus that contractual rights to cashflows constitute property protected by the Fifth and Fourteenth Amendments. See Eastern Enterprises v. Apfel, 524 U.S. 498 (1998), Webb’s Fabulous Pharmacies, Inc. v. Beckwith, 449 U.S. 155 (1980). Stocks, bonds, and most other financial instruments are thus protected from instantaneous nullification.

Second, the Supreme Court has set out two separate theories under which nationalization of financial institutions may constitute a taking. Per the 2005 decision that Mayer relies on (Lingle v. Chevron U.S.A., 544 U.S. 528), regulations that completely deprive an owner of “all economically beneficial use” of her property trigger the Fifth Amendment unless they fall into
certain narrow safety and nuisance exceptions. Alternatively, under a test articulated in *Penn Central Transportation Co. v. New York City*, 438 U.S. 104 (1978), judges determine whether a taking occurred based on the type of government action, whether the regulation had an adverse economic impact, and the extent to which the regulation “interfered with distinct investment-backed expectations.” A forcible change in the capital structure of a previously un- or under-regulated entity would certainly look like a taking under either of the two tests.

Third, just because the government can currently force banks and thrifts into receivership, doesn’t mean that it can constitutionally do the same to any other enterprise. Decisions evaluating shareholder claims for regulatory takings of the type governed by *Penn Central* often revolve around the degree to which an entity that suffered economically because of government action knowingly did business in an area fraught with complex, changing rules. For example, a 2003 federal court of appeals case focused on the right of both public entities (former RTC/subsequent FDIC) and private owners to recover a surplus allegedly lost when a change in accounting practices brought about by Congress in 1989 (*FIRREA*) forced regulators to seize Security Savings, a previously viable S&L organization. *Bailey v. United States*, 341 F.3d 1342. The court held that the alteration of the accounting rules was not a *per se* taking under the theory that the S&L voluntarily participated in and reaped the benefits of the deposit insurance system, articulated in a seminal 1996 case *Branch v. United States*. Problematically, the opinion then dodged the question of whether such an administrative move nonetheless constituted a distinct, regulatory taking by holding that a statutory cost recovery hierarchy for liquidated thrifts would have prevented the private parties from seeing any cash in the first place. In other words, *Bailey* explained that shutting down an insolvent entity operating in an environment of pervasive government control would not itself constitute a taking, but did not fully resolve how one should treat a sudden administrative change that led to this insolvency in the first place. Indeed, an earlier case in the same court allowed a taking claim to go forward on the grounds that a 1991 law similar to *FIRREA* reneged on a signed promise by the FDIC to consider a bank’s capital reserves adequate. See *First Hartford Corporation Pension Plan & Trust v. United States*, 194 F.3d 1279 (1999).

The legal doctrine in these areas is quite complex and there are probably several ways to apply it to various existing and future economic recovery programs. I do believe, however, that entities negatively affected by nationalization/conservatorship/receivership brought about under a brand-new program occur could make a very good argument that they are entitled to restitution under the Fifth Amendment. If that is the case, Congress can’t do anything to change the outcome. Of course, courts would still have to decide on the extent of “just compensation” that would remedy an otherwise illegal seizure. Historically, such awards have been based on market value, but the inquiry could get quite muddled in the financial arena. Yet any judicial decision that would force the government to pay something close to market value for the liabilities it wrote off would by definition render such restructuring moot. Perhaps this is the reason why the Obama Administration had previously adopted the *wait-and-see/just-in-time* approach to bank rescues.
Mar 25, 2009 8:16 AM

**Room For Debate At The NYT**

from **The Baseline Scenario** by Simon Johnson

The NYT ran an online discussion of the new Geithner Plan yesterday. The worry I expressed there is whether the Plan is scalable - i.e., it could work at a modest level, but to really have impact it needs to be huge. And, as it gets larger, I think we’ll see a political backlash.

Looking back over the comments of the day, my position put me closer to Paul Krugman but not too far also from Mark Thoma (look at his response to me, further down the discussion). Brad DeLong came across as the most positive, but even he is doubtful that the planned purchases are large enough - he makes the point that the Administration couldn’t get Congress to agree on any additional money for this purpose, but this puzzles me.

The Administration (1) has not really made this case on Capitol Hill (my contacts there tell me), (2) is asking for lots of money to do other things (their strategy was overweight fiscal from the start), (3) hasn’t communicated well a more general sense of priority or urgency - if we don’t fix our banking system how many other good things are possible over the next decade?

*By Simon Johnson*

Mar 24, 2009 8:59 PM

**What Is a Non-Bank?**

from **The Baseline Scenario** by James Kwak
I’ve read the NYT and WSJ articles, and the prepared testimony by Bernanke and Geithner, and I have a very basic question. Bernanke and Geithner said they needed new power over “systemically important nonbank financial firms” or “large, interconnected, non-depository financial institutions” or, most simply, “non-banks.” This is to complement the FDIC’s existing power to take depository institutions (“banks”) into conservatorship.

Are bank holding companies “non-banks,” which happen to have “banks” as subsidiaries? If so, the legislation they are asking for should make it easier to nationalize a large, complicated thing (I don’t know what to call it anymore, but you know what I mean) like Citigroup. Various people arguing against nationalization have said that while the government has the power to take over the depository institutions within Citigroup, it can’t take over the umbrella entity; this would eliminate that problem.

If so, I would call that a good thing. But I can’t find the answer.

Update: Thanks to the commenters. And to Yves Smith. So the Fed has regulatory authority over bank holding companies (that bit I already knew), but there is no defined process similar to what the FDIC does for taking over and winding down failing institutions.

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Mar 24, 2009 3:02 PM

Banks Find New Way to Hold Up Government

from The Baseline Scenario by James Kwak

From The Wall Street Journal today:

Some bankers say they turned the conversations into complaints about the antibonus crusade consuming Capitol Hill. Some have begun “slow-walking” the information previously sought by Treasury for stress-testing financial institutions, three bankers say, and considered seeking capital from hedge funds and private-equity funds so they could return federal bailout money, thereby escaping federal restrictions.
Ummm . . . if they could get capital from hedge funds and private-equity funds, wouldn’t they have done so already? And they are now resisting the stress tests? Simon is usually more negative about banks’ recent behavior than I am, but I’m catching up.

Distressingly, the article is mainly about how the administration is trying to “fix” this situation by offering greater access to Wall Street leaders. Apparently they actually tried to freeze out the bankers early in the administration, but recently changed course.

By James Kwak

Will It Work?

from The Baseline Scenario by James Kwak

Leaving aside the question of subsidies, which has gotten piles of attention on the Internet, Simon and I are skeptical that the Geithner Plan will achieve its basic objective: getting enough toxic assets off of bank balance sheets to restore the financial system to normal functioning. We discuss this in today’s Los Angeles Times op-ed, although our regular readers could probably fill in the blanks by themselves.

Update: At 2:30 PM Eastern today, I’ll be on a live chat at Seeking Alpha with Felix Salmon and possibly Brad DeLong and Mark Thoma discussing the Geithner plan. Salmon is strongly against, Delong is moderately (strongly?) for, Thoma is moderately for.

Update 2: At The New Republic, Simon discusses one plausible scenario under which the Geithner Plan is the first step in a comprehensive bank rescue strategy. But he’s skeptical that we will see the other necessary steps.

Update 3: Chat is done; replay is here.

By James Kwak
The Cultural Costs of Bailout Nation

from The Baseline Scenario by James Kwak

This post was written, at my request, by Carson Gross, one of our regular readers and a multi-talented person I have worked with in the past. (We met one night when I needed help debugging a classpath error I was getting on my computer.) I don’t necessarily agree with what he says, but I think he has something valuable to say. Everything below is by Carson.

James asked me to elaborate on a comment in which I worried about the public’s reaction to the real or perceived wealth transfers occurring during this financial crisis - in particular, how that reaction would manifest itself culturally.

“Wealth transfers” is a charged term, and a lot of smart people have spent a lot of time patiently explaining that, in fact, most of the bailout thus far involves loans and that, under some models (which, apparently, don’t include housing prices regressing to roughly 3x incomes, where they have been for most of history) we, the taxpayers, may actually end up making money on this whole thing. I think that’s fanciful, but I’m not going to debate that here. Rather, I want to focus on the bailout’s cultural impact.

I assert, without proof, that the proverbial man on the street sees the words “bailout” blaring on his TV and computer screen day in and day out, and doesn’t care to look too deeply into the details. Who can blame him? He has enough of his own problems to deal with without attempting to decipher deliberately impenetrable financial jargon. Even if the government is getting reasonable compensation for the capital injections in some cases, the man on the street just sees more of his tax dollars going into banks to pay out people who make orders of magnitude more money than he’ll ever see. That’s his reality.

And, despite the tut-tuting that this is a shallow view of what is happening currently, I think his view is correct in a deeper sense: the wealth transfers have already occurred, during the boom, when no one was looking. The money has already been sucked out, we all know it, and now it comes down to who holds the multi-trillion dollar bag. The banking industry doesn’t produce
wealth: it is there to efficiently allocate capital between alternative uses in the broader economy. Therefore the replacement wealth will have to come from somewhere else. People in the real economy sense, correctly, that it’s going to come from them, be it through inflation, higher interest rates, higher taxes, or some combination thereof.

How will this realization affect the culture and how will that, in turn, affect our economy? Here are three changes that I see: one that is happening, one that is imminent and one that has already occurred:

- Currently, in the broad culture, a “where’s my bailout?” meme is becoming increasingly dominant. You can see it written on the faces of auto executives as they go before Congress and you can see it in the debt-relief ads playing off the various bailout programs that have sprung up on TV. This dependent mentality has been devastating in other countries and ages, and will lead to decreases in productivity as people simply give up, muting an economic recovery.

- Imminently, in industries other than banking, high earners will increasingly resent the higher taxation they are being asked to shoulder to fund the bailout. This will cause further, and more severe, decreases in productivity. This is speculation on my part, since no one has been asked to pay higher taxes yet. However, based on the conversations I’ve had with friends and colleagues over the past few months, I believe that this will indeed happen. When smart, dynamic people start throwing in the towel, the real economy loses a huge source of productivity.

- Finally, consider the astonishing revolution in homeowners’ attitudes towards defaulting on a mortgage that has occurred in just the last 18 months. Defaulting has gone from being a mark of shame, to an understandable misfortune to, almost overnight, a smart financial move. Eric Hovde comments on this radical change in this CNBC video at the 9:30 mark. It’s a truly scary sort of cultural change. Mortgages were the most stable private financial transactions we had to build our banking system on. Can banks in good faith offer the mortgage rates that they once did, after the government has withdrawn pressure from them? We’ve fundamentally changed the risk of holding mortgages, making them more risky. Eventually the market will reflect this, whether we like it or not.

There may be technical solutions to the banking problem. However, if those solutions do enough damage to the cultural framework on which the system was based in the first place, even the most brilliant among them will be useless. The eye-rolling from both the academy and Wall Street when people make moral arguments regarding the bailout is short-sighted and, ultimately, ignorant technocratic. Paraphrasing C.S. Lewis: we must not saw off the bough that we are sitting on.

Step one: stop cutting.

Posted by James Kwak
Warning: This is a post about economics and politics; it is a reader response post; but (here’s the warning), it’s also one of those annoying self-referential posts you only see on the Internet discussing a debate among the commentariat.

Last week went something like this:

1. We learned about the $165 million in retention bonuses at AIG Financial Products.
2. A lot of people, up to and including President Obama, got mad.
3. Various commentators, including Ian Bremmer (on Planet Money, around the 14-minute mark) and Joe Nocera, said, in Nocera’s words, “Can we all just calm down a little?”

Their argument is basically that $165 million is small change, the government should be working on bigger issues, and the demonization of AIG is making it harder to solve the real problems.

Andrzej Kuhl, a former colleague of mine, put it well in an email to me after reading our New York Times op-ed:

I feel that the timing of the piece is harmful and its final conclusion is too limited.

Don’t take me wrong, I am a strong believer in compensation plans being tied to performance. And not just a short term - one year - window, but a performance measured over a multi-year period. Ideally, compensation enhancements should have multiple parts, ranging from evaluation of the performance of an individual, to that of a larger unit within which the individual performs. I also believe that all individuals are replaceable and should be moved aside if their performance has been sub-par (and bringing a company to the brink of bankruptcy is definitely below par).
Having said that, I strongly believe that the current brouhaha over bonuses at AIG, and other TARP recipients, has reached the level of a national hysteria. What should be an effort for some lower level functionaries, has been occupying front pages of newspapers, tying up valuable time of top government officials (including the president), as well as encouraging members of the congress to pontificate in circus-like hearings and propose retroactive tax legislation of dubious legality. In effect, our leaders are following, or being forced to follow, the angry crowds. But history also teaches us that such crowd-pleasing games, just like feeding a few Christians to lions, only obscure current problems and defer their resolution.

Ironically, those same historical facts described in your article could have been used to present a much broader set of recommendations. Rather than adding fuel to the fire (focusing on the lack of justification for retention bonuses), you could have called for a radical restructuring of the financial services industry and its compensation practices.

After all, even if we claw back the $165M (or even the $218M reported by Reuters today), the economy will still be in shambles and the mind set among the leaders of financial services establishments will not be much changed. On the other hand, if we can muster as much bi-partisanship into congressional work on budget, economy rescue plans, financial services regulations, etc. as we witnessed on the “bonus tax” proposal, we could be a step closer to the real solution.

I think there are two separate issues. On the first issue, I agree completely with Andrzej, and in large part with Bremmer and Nocera. I began my first post on this topic with these words: “$165 million, of course, is less than one-tenth of one percent of the total amount of bailout money given to AIG in one form or another.” I agree that the bonuses have an insignificant direct economic impact. I also agree that the furor that erupted over the bonuses has made it harder to solve our big problems. Not only have the president, his economic team, and Congress been distracted by Bonusgate, but the public backlash will make it much harder for the administration to get money from Congress when they do need it - not only as the economy deteriorates, but even when it comes time for things like health care and education.

At the same time, let’s not forget that Bonusgate has also had some positive effects. First, though small in itself, it strikingly illustrates a broader issue of tolerating business at usual in a failing financial sector. Scond, it has finally made the administration realize that there is a political cost to repeated generous bailouts of the financial sector.

The second issue is more complex. Bremmer and Nocera basically say, “calm down.” (Andrzej says something more subtle, which I will get to in a bit.) In Bremmer’s words, “if you are a subsistence worker, outrage is a luxury you cannot afford.” I’m not sure what this is supposed to mean. Outrage is an emotion, not a rational choice. Blaming outrage is like blaming greed: it’s an unavoidable part of the human condition. The question is whether we can do anything about it.

Bremmer, Nocera, and (to some extent) Andrzej blame our political leaders in Washington for indulging in populist bonus outrage instead of acting like responsible adults. But this raises an interesting question about the relationship between economic policy and democratic politics. I’m
no expert on democracy, but I can make a couple of basic observations. We live under a
democratic system. We want our elected officials to be sensitive to the concerns of their
constituents. We don’t necessarily want them to *do* everything that a majority of people want -
they are supposed, to some extent, to resist popular pressures and instead do what is in the public
interest - but at the same time we get very upset when they seem to ignore popular opinion, or
seem out of touch with popular opinion. When that happens, an administration can lose popular
legitimacy, and without popular legitimacy, it will find it very difficult to get Congress to
cooperate.

This is the risk the Obama administration now faces, as eloquently described by Frank Rich.
Even if the administration officials believe that Bonusgate is a distracting sideshow - as they
probably do - they cannot simply ignore, or belittle, the concerns of Main Street; if they do that,
they lose whatever ability they have to solve our “real problems.” I think that the last
administration was at fault for not dealing with the bonus issue back in September, and the new
administration is at fault for not dealing it when it learned about it. But that’s water under the
bridge, and Washington has to meet the public partway. And I think that is what Obama was
trying to do.

This is not a country where technocrat-economists can design perfect policy solutions and
implement them without regard for public opinion, nor would we want it to be. As I said in a
recent post, I have made the mistake of thinking that an ideal solution could be imposed without
taking proper consideration of the political difficulties involved. In the country we have, the
ability of the government to implement the “right” policy solutions depends instead on its
popular legitimacy, which means at a minimum feeling the public’s pain.

Now, Andrzej raised a slightly different issue: whether I (and, by extension, the many
commentators who piled onto this issue) am at fault for helping to stoke bonus outrage. President
Obama has to be sensitive to popular opinion; I don’t. In my case, Simon and I wrote an article
trying to debunk one of the arguments for the AIG bonuses. We wrote it first because we
believed what it said, and second because we thought its relevance went beyond AIG, since it
dealt with the broader question of whether failed institutions can hold up reform by insisting that
only they can fix the problems they created. So the question is whether we should have published
it or not. (I agree with Andrzej that a better outcome of Bonusgate would be a systemic fix for
flawed incentives in the financial industry. But publishing the article you most want to write, for
reasons I won’t get into here, usually isn’t an option, unless you have your own column.)

Perhaps from a narrow utilitarian perspective one could argue that the article did more harm than
good, because it contributed to the outrage that is making it harder for the administration to get
real work done. From a broader perspective, however, one could argue that the value of the free
exchange of ideas outweighs the short-term costs generated by the article. Of course, there is no
way of quantifying and weighing these costs and benefits. And in any case they are probably
relatively small either way; I don’t want to make the mistake of exaggerating my own
importance.

In summary, I agree that Bonusgate has had some negative consequences (along with its positive
ones), but I’m still comfortable with my small contribution to it. If we were much, much bigger,
then perhaps I would pay closer attention to the potential consequences of what I write. But for
now I’m willing to write pretty much anything I believe to be true.

Mar 23, 2009 10:21 AM

Let the People In

from The Baseline Scenario by James Kwak

The Geithner Plan is out. I don’t have time to look at it in detail, but in the meantime, PK, one of
our readers (and someone we correspond with a lot), had an idea: If we’re going to subsidize the
private sector, why not let individuals into the deal? In his words:

If Geithner’s taxpayer subsidized toxic public/private plan goes forward, I think it would be fair
if the federal government allow non-institutional investors to participate via a no-fee investment
vehicle. I think if Americans had the option of investing in this program (without having to pay
the egregious fees to the investment advisors/PE shops), it would be much easier to swallow
since they would at least get the same deal the sharks are getting. There is probably more money
on the sideline with individual investors than all these institutional investors. Maybe they could
set up some ETF equivalent for it. I think the willingness of the administration to do such a thing
would tell us a lot about whose for whose interest they are really looking out.

Capital for the investment funds will come from private fund managers (raising new capital from
their limited partners) and from Treasury. Perhaps either a fund manager or Treasury could
create an ETF- or mutual fund-type structure, where the government subsidizes the usual
management fees, and use that to raise some of the capital. I know that because most individuals
aren’t “sophisticated investors” this would subject the fund - or at least the individual part of it -
to a higher degree of regulation, but that doesn’t seem like a bad thing.

I think it’s a brilliant idea.

(As far as the plan itself, my first reaction is that the Legacy Securities Program actually doesn’t
do enough to attract private sector participation, since the leverage is only 50% or maybe 100%
of the capital.)
Update: Matt Yglesias and F. Blair (below) have pointed out the following language: “The program will particularly encourage the participation of individuals, mutual funds, pension plans, insurance companies, and other long-term investors.” I believe that’s from the program for loans, not securities (the latter involves up to five professional asset managers, who generally raise their money only from qualified investors). So maybe there is something there.

By James Kwak

Mar 23, 2009 7:20 AM

Breaking The Bank

from The Baseline Scenario by Simon Johnson

My problem with Monday’s expected announcement from Mr Geithner doesn’t have much to do with the details of the public-private partnership. I doubt this will work, because I don’t see the incentive for banks to sell assets at less than the value currently on their books. Right now, they have the government right where they want it - look at the body language and words of leading CEOs.

The government feels that it cannot take over large banks, there is no bankruptcy-type procedure that would work, and only deference to the CEOs of major financial institutions can get us out of this mess. This is a conscious strategy decision from the very highest levels.

I’d like to say: OK, but this is absolutely the last time we will try for a solution to our banking problems involving a private sector-led approach. Of course this would not be credible and bank CEOs know this. Instead, I propose the following.

If Secretary Geithner’s scheme works, we draw the lesson that our banks became too big and we aim to make them smaller relative to the economy moving forward. The regulatory agenda currently in progress - including for discussion at the G20 next week - would do essentially nothing to reduce the political power of big banks. We need simple caps on bank size, leverage relative to the economy and - this is harder - measures of interconnected tail risk (i.e., is
everyone making the same kind of crazy loans?). Design a system with this in mind: regulators get captured and super-regulators get super-captured.

If the scheme doesn’t work, we draw the exact same lesson. And, of course, we should expect Chairman Bernanke to move forward with his Plan B (or is it Plan Z?): inflation.

In any case, our top political leadership needs to really sell some version of the following message. We let the banks get out of control and the cost will be enormous; our debt/GDP ratio will in all likelihood rise from around 40% to over 80%. We cannot afford to have the same problem again. We must break the power of banks before they break us all. And if you don’t think banks can do that much damage to economies, just look around outside the United States - the world is full of countries where growth is slowed or distorted by a financial system that becomes too powerful. This is not about tweaking the existing U.S. regulatory system; it is about complete change and - in many senses - turning back the clock to a financial system that was simpler, smaller, and much less dangerous.

*By Simon Johnson*

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Mar 22, 2009 11:18 PM

**Exploding Cars for Beginners**

from *The Baseline Scenario* by James Kwak

**Mark Thoma** does a nice job comparing government purchases, public-private partnerships, and nationalization, and gets the concluding paragraph exactly right. It won’t help you through the complexities of whatever Geithner will announce in the morning, but it explains the basic concepts.
Reader Questions: Nationalization

from The Baseline Scenario by James Kwak

If I had infinite time, I would respond to all reader questions and suggestions. Unfortunately, I can’t. But I’m hoping to occasionally post some in-depth responses to some of the tougher questions we get.

Chris Uregian, one of our readers, sent us three questions by email. In summary, he thought that we were overlooking some of the problems with nationalization and the reasons why Treasury might be moving more slowly than we would like. I originally answered him in email but we later decided this would be good to post to everyone, and Chris gave us his permission. I am going to copy his questions here and add a response after each one.

1. Question:

We have heard plenty about the Swedish model. But how about the US model. The last time a bank was nationalized in the US, it was Continental Illinois in 1984 - 1994. That was the 7th biggest bank at the time.

If we nationalize Citi (ideally only Citi, although no one outside the Treasury, even Simon or Paul Krugman have any idea how many banks we need to nationalize), that is X times larger than Continental, how long do we have to hold it for? What is the cost to the taxpayer?

If we have to nationalize even 2 out of the 4 biggest banks in the US, that is around 30% of total banking sector assets according to Martin Wolf. So the US Government will officially be in charge of at least a third, more likely half the US banking sector for anywhere between 5-10 years. You guys do excellent forecasts, so tell me is that a reasonable forecast of what nationalization would look like? If so, and you were Tim Geithner, wouldn’t you try to avoid this at almost any cost? Shouldn’t nationalization be your very very LAST resort?

Roubini, for all his gloom, is currently the most reasonable of our nationalization crew. He recognizes that the Treasury really wants to avoid nationalization for political but also genuine economic reasons, but that is why their plan gives banks 6 months to find private capital. His argument is that in 6 months time, ’in the depth of the recession, we will really know which banks are really insolvent, and which ones could be solvent with a little government help. The notion that there is a clear distinction between insolvent banks and illiquid banks is a little strange to me given my experience… there’s a grey area with many shades and defining clearly
which banks are insolvent in this economic environment is not easy. Again, that suggests caution and moving slowly, not jumping at solutions Paulson style.

Guessing how long the government would be in charge of these banks is basically impossible, but I think 5-10 years is not an unreasonable guess. I don’t think that means it should be the last resort, however. The problem is the real economy. The longer we have uncertainty, the worse the real economy gets. On the one hand, I agree with you and Roubini that time will give us a clearer picture. On the other hand, I think that the banking sector is not going to fix itself on its own, and the longer we wait the bigger the output gap (and the higher the unemployment rate) will be by the time the economy does recover. So I think reasonable minds can disagree on this.

2. Question:

Further, I think Simon’s point about if you covered the name of the country, then your IMF officials would give the same advice to the US as for any emerging market economy strikes me as missing one crucial detail. Citibank is not your typical Latin American bank - if a Latin American bank goes bankrupt, that doesn’t carry the risk of freaking out markets globally the way Lehman’s bankruptcy did due to counterparty risk, it does not have the number of creditors, bondholders fearing they will get a massive haircut that Citi has; You simply cannot tell me that if 2 out of 4 largest banks were nationalized overnight, that would not carry a very serious risk of freaking out the markets at least as badly as Lehman’s bankruptcy did, and potentially lead to the collapse of the stockholder confidence in a whole bunch of financial institutions that may well be healthy.

I think market freakout depends on the form of the takeover. As I have written (maybe since you sent this email), the main determinant of market freakout will be how creditors are treated. One possibility, which Krugman somewhat hesitantly endorsed, was to guarantee the bank liabilities. Another, which Bebchuk suggested, was to guarantee the liabilities up to some level (which could vary by type of creditor), where that level was engineered to minimize the risk of major collateral damage. I think with sufficient time to study the situation, it seems like you should be able to force some degree of debt-for-equity swaps without causing a huge domino effect. But a blanket guarantee is still an option.

3. Question:

Finally, let me remind you that Peter and Simon wrote a piece in the FT just over a month ago arguing AGAINST nationalization. Now, they are all for it. Yes, when the facts change, we change our minds…. but recognize that Tim Geithner and Ben Bernanke do NOT have the option to change their minds. And they are NOT suddenly sell-outs or economic illiterates. But maybe they know too much about how close we came to the precipice and have become excessively risk averse. Perhaps. But quite honestly, I am not sure I blame them for wanting to be extra prudent. Back in September, the vast majority of the financial commentariat said Paulson made the right decision to let Lehman fail - it was not too big to fail. Now it’s the biggest mistake since Mellon liquidated the US banking sector. In such a crisis, certainty is not justified and should be left to the Rick Santellis of this world. At a time when Paul Krugman is
disagreeing with Alan Blinder, maybe each side needs to listen more to the arguments of the other.

About the argument against nationalization back in January: I think the honest answer is that the thing we proposed then would have been preferable to nationalization, but it had very little chance of working. We made the mistake of describing an economically elegant solution that did not take political realities into account. Our proposal was for the government to buy toxic assets at market value (or something close to it) and then recapitalize the banks directly, at the same time. This would remove balance sheet uncertainty from the banks while minimizing the taxpayer subsidy. The mistake was in overestimating the power of the government to force such a solution. The problem that I have since realized is that as long as the banks can negotiate on their own, they will win that particular game of chicken. They will just say, “no, I won’t sell to you at that price” and wait for the government to propose a sweeter plan - because the government can’t walk away, because it’s responsible for the economic well-being of the country.

At the end, Chris wrote: “I fear you have not been as clear on the downsides of nationalization as you have been on the benefits, which might help explain why the Administration is ‘dithering’.” I think that’s a fair criticism. Hopefully I’ve helped redress that.

By James Kwak

Mar 21, 2009 7:16 PM

This Time I’m Not the One Calling It a Subsidy

from The Baseline Scenario by James Kwak

According to The New York Times and the The Wall Street Journal, the Treasury Department is set to announce its plan for troubled assets early next week. It will include three components. The details aren’t clear since these are anticipatory news stories, but it will be something like this (combining bits of information from the two stories):
1. The FDIC will create a new entity to buy troubled loans, with the government contributing up to 80% of the capital and the remainder coming from the private sector. The Fed or the FDIC would then provide non-recourse loans* for up to 85% of the total funding (NYT), or guarantees against falling asset values (WSJ), which more or less amount to the same thing.

2. Treasury will create multiple new investment funds to buy troubled securities, with Treasury contributing 50% of the capital and the rest coming from the private sector. It’s not clear from the news stories, but I think it’s highly likely that these funds will also benefit from either non-recourse loans or asset guarantees.

3. The Term Asset-Backed Securities Loan Facility (TALF) is a program under which the Fed was already planning to buy up to $1 trillion of newly-issued, asset-backed securities** (backed by car loans, credit card receivables, mortgages, etc.). The idea was to stimulate new lending in these categories. This program will be expanded to allow the Fed to buy “legacy” assets - those issued prior to the crisis. This enables the Fed to buy toxic assets off of bank balance sheets.

Instead of coming up with one plan to buy troubled assets, it looks like the government has come up with three. (As Calculated Risk said, however, ” More approaches doesn’t make a better plan” (emphasis in original).) For now, I think the concerns I expressed last month still hold. If we take as given that the government will only negotiate at arm’s length with the banks (meaning the banks can decide at what price they are willing to sell the assets), then the most important thing is for the plan to work. But it’s not clear if the degree of subsidy offered will be enough to close the gap between what investors are willing to pay and what banks are willing to sell at. Having multiple buyers and using cheap Fed financing will increase the willingness-to-pay for these assets, but we won’t know a priori if it will exceed the reserve price of the sellers.

In the best-case scenario: (a) the government’s willingness to bear most of the risk encourages private investors to bid enough to get the banks to sell; (b) the economy recovers and the assets increase in price from the prices paid; (c) the investment funds pay back the Fed (which makes a small spread between the interest rate and the Fed’s low cost of money); and (d) the government gets some of the upside through its capital investments. (I think the main purpose of that government capital is to deflect the criticism that all of the upside belongs to the private sector.) In the worst-case scenario, the market stays stuck because the banks have unrealistic reserve prices. Perhaps the idea is that, in that case, the TALF will allow the government to (over)pay whatever it takes to bail out the banks.

Most encouragingly, the headline in the Times was “Toxic Asset Plan Foresees Big Subsidies for Investors,” indicating that the mainstream media have figured out the game. (By contrast, the Times headline announcing the bank-friendly terms of the Capital Assistance Program was “Government Offers Details of Bank Stress Test.”) I may soon be out of a job. (Wait a sec, no one is paying me for this . . .)

* A non-recourse loan is made for a particular asset or set of assets. If the borrower fails to pay off the loan, the most the lender can get is the asset (he cannot go after the borrower’s other
assets or income streams), so the borrower’s loss is capped at the amount he pays himself. Mortgage loans are non-recourse loans where the borrower’s loss is capped by his down payment.

** Technically, the Fed would loan money to financial institutions and take asset-backed securities as collateral. However, these would be non-recourse loans, so the financial institution could pay off the loan simply by ceding the collateral to the Fed. (It seems to me that because these are loans, if the assets appreciate in value, the financial institutions could choose to pay back the loans and take the collateral back, thereby getting all the upside, but I’m not certain about that.) The TALF will be capitalized by some money (10-20% of the total) coming from Treasury, which will absorb the first losses.

By James Kwak

Mar 21, 2009 11:31 AM

Modifying Securitized Mortgages

from The Baseline Scenario by James Kwak

Amidst the gallons of ink spilt, here and elsewhere, over the nationalization debate, the AIG collateral payments, and the AIG bonuses, I neglected to comment on the details of the new housing plan, which were released on March 4. When the initial plan was announced in February, I was concerned about the seeming lack of any provision that would enable servicers of securitized mortgages to modify those mortgages without being sued by the investors who bought the securities. (In brief, the problem is that the pooling and servicing agreements (PSAs) that govern those securitizations may not allow loan modifications, or may require the servicer to gain the consent of all of the investors, which is practically impossible.) People who know housing better than I said there was something in there.

If it is, I still can’t find it in the March 4 documents (fact sheet, guidelines, modification guidelines). In any case, an important question is whether the plan will do enough to encourage servicers to modify securitized mortgages, as opposed to mortgages they own. “A New Proposal for Loan Modifications,” a short (13-page) paper by Christopher Mayer, Edward Morrison, and
Tomasz Piskorski that will appear in the next issue of the *Yale Journal on Regulation*, describes the problem clearly and makes three proposals to solve it. (A longer version with appendices is available [here](#).)

The problem, as described in Part 1, is that servicers for securitized mortgages do not have the incentive to maximize the economic value of the mortgages, but rather to maximize their servicing fees and avoid lawsuits from investors, which leads them to foreclose in situations where a servicer that owned the whole mortgage would make a modification. To get around this, they propose three things:

1. Incentive fees to servicers of 10% of all payments made on securitized mortgages, in order to provide them with the incentive to maximize the stream of mortgage payments.

2. Compensation to lenders of second liens, in effect paying them not to hold up a loan modification.

3. New legislation protecting servicers from lawsuits by their investors.

The last proposal raises the issue of the Takings Clause of the Fifth Amendment, “nor shall private property be taken for public use, without just compensation,” which could be interpreted to mean that legislation affecting the rights of investors in mortgage securities is unconstitutional. The authors make an argument, complete with multiple Supreme Court citations, that that interpretation would not be correct in this case. (The Takings Clause is implicated by other policy issues raised by the crisis, such as the recent legislation to impose punitive taxes on bonuses.)

The administration’s housing plan, as far as I can tell, provides a different form of #1 (flat cash incentives for modifications, rather than incentives based on the stream of payments), and some form of #2, but doesn’t directly address #3. (By the way, if you’re interested in the mechanics of how loan payments will be reduced, it’s on pp. 3-8 of [these guidelines](#).)

*By James Kwak*

Mar 21, 2009 6:47 AM

**CEO Semiotics And The Economics Of Vilification**
CEOs of major banks have started to push back against the critics - their primary job, after all, is lobbying (rather than, say, risk management). As such, they are typically sophisticated communicators who use a wide range of symbols, words, and modes of communication to get their points across.

Not everything they say, of course, should be overinterpreted. For example, calling the hand that feeds the banks “asinine” (Richard Kovacevich, chair of Wells Fargo) seems more like an outburst than a promising way to enhance shareholder value - even if he is correct about whether today’s stress tests are actually meaningful.

Lloyd Blankfein’s February FT op ed famously made the case that we need banks as a “catalyst of risk.” But this argument raises awkward questions. What does Goldman Sachs know about risk, and when did it learn this (presumably recently, after they settled up with AIG)? My risk-taking entrepreneurial contacts feel their catalysts should be somewhat smaller relative to the economy - so these banks/securities underwriters can, from time to time, go bankrupt without threatening the rest of the private sector (and everyone else) with ruin. Still, the main point of this FT article was the symbolism of the timing, appearing on the morning of what was scheduled to be Secretary Geithner’s first big speech; we were supposed to read Mr. Blankfein’s conceptual script, then look up and see the Secretary on TV.

Vikram Pandit’s recent letter to Citi employees was a nicely timed communication to his broader social and political audience. His upbeat note was plausible because he put down some very specific markers, e.g., “best quarter-to-date since 1997”; the danger is that these come back to haunt him. And as a document making the case for big banks more generally, it was weak.

The banking industry’s thought leader right now is definitely Jamie Dimon. His point about vilification is straightforward.

Dimon gently points out that unless we stop vilifying corporate leaders (and presumably he would say the same of traders this week), we will not get an economic recovery.

And, at some level, he must be right. If you create enough uncertainty around the future rewards for any activity, e.g., trading securities, setting up new companies, or fishing, you can easily get less investment of time and effort in that activity. You may also, of course, get more speculative behavior as time horizons become shorter - i.e., “take the money and run” becomes more attractive relative to building up a reputation for good behavior.

“We are where we are,” is something I’ve heard (in other contexts) from people with authority who have screwed up very badly but who know that everyone wants and needs to move on.

But the reality in banking is somewhat more complicated, for three reasons.
1. We don’t know how much of banking profits in recent years were illusory and should not have been booked as GDP. In fact, it would not be a big surprise if - eventually - we go back and mark down our true production of goods and services in 2007 by 2 or even 5 percent. In this sense, we face a statistical situation similar to that of the Soviet Union at its demise - once they figured out that all their military production had no real value, they had to reduce measured GDP sharply. It is not compelling to say we should necessarily go back to where we were in banking.

2. Clean-ups in banking and most other activities require bringing in new people. But, as the AIG discussion over the past week has made clear, much of the finance industry has not yet reached the point where they see this as essential. This is about good housekeeping, not vilification.

3. Going forward, Mr Dimon concedes that being Too Big To Fail is bad, but he does not apparently see the logical consequences. Not all bankers made business-ending types of mistakes, but some did and under our current business-as-usual course, we will end up with fewer big players. Mr Dimon proposes changing something (vague) about regulation and bankruptcy so that the taxpayer need not be afraid of the new behemoths failing. But this cannot possibly be plausible, after all today’s problems are largely the result of weakly enforced regulation and politically powerful banks; in the future this imbalance will worsen.

There may well be short-run costs (i.e., in ways that really hurt: lower growth, more unemployment) to properly cleaning-up and restructuring the banking system. The exact size of these costs is hard to know, but we should face reality on this point - there is a potential tradeoff between presumed costs of bank reform today and longer-run improvements in our sustainable growth potential.

But the real question is bigger. Can we continue to live with the risks involved in having banks that are large relative to GDP and politically very powerful? Banks of that size cannot commit not to screw up. In fact, the people who work for them will know - based on what they have seen so far - that even if future bailouts do not ultimately save the business, one way or another, they will walk away with a lot of stuff.

Tell me if you perceive an alternative, but I can’t see any sensible way forward that does not involve breaking up large banks and making sure they stay much smaller relative to GDP. This is surely not sufficient for stability and prosperity in the future, but right now it appears unavoidably necessary.

*By Simon Johnson*
I got this from some friends who have an 8-year-old daughter whom I’ll call Franny:

Friend (looking at Franny’s artwork, which is labeled “$10,000”): How much do I have to pay you for that picture?

Franny: $10,000.

Friend: Is that in real money or pretend money?

Franny: You can pay me $5,000 in real money and $5,000 in pretend money. And if you only want to pay me the pretend money, then you get to borrow the picture for the weekend.

I’ve been struggling for weeks trying to think of the perfect real-world analogy - maybe something to do with assets being held on the books at $10,000 that everyone knows are only worth $5,000. Maybe one of our readers can come up with right answer (like in The New Yorker’s cartoon caption contest).

By James Kwak

Mar 20, 2009 10:49 PM

Zvi Bodie on Personal Finance

from The Baseline Scenario by James Kwak
Occasionally we get personal finance questions. Actually, we’ve gotten fewer of those questions lately, perhaps because readers realize we don’t have much to offer on that score, and that we try to avoid anything that might sound like investment advice.

Zvi Bodie, whose name you may have seen here before, has thought a lot about personal investing, and agrees with some of the positions I’ve offered here: notably, that most information about personal finance available on the market is not worth listening to. Bodie recently posted a series of 3-minute webcasts to the Boston University School of Management website where he lays out some basic advice on saving for retirement, including some of the implications of the current economic crisis. I didn’t watch all of them, but I liked how accessible they were.

By James Kwak

Mar 20, 2009 3:16 PM

More Housekeeping: PDF Archives

from The Baseline Scenario by James Kwak

At the request of several readers, I’ve printed entire months of blog posts to PDFs for download. There is also a “Download the Blog (PDF)” link in the sidebar under navigation. This might be useful for new readers who want to catch up on a plane, or something like that.

I did this in a very low-tech way (explained after that link) so if you have suggestions for how to do it faster or more elegantly please post them there.

By James Kwak
Why Bail Out AIG’s Creditors?

from The Baseline Scenario by James Kwak

Simon and I wrote on op-ed in the New York Times today, trying to debunk the idea that, as we put it, “A.I.G.’s traders are the people that we must depend on to save the United States economy.” The AIG bonus fiasco, as I’ve written earlier, has been particularly useful in raising the political cost of the administration’s current bailout strategy. But, as I said then, “$165 million, of course, is less than one-tenth of one percent of the total amount of bailout money given to AIG in one form or another.” And as far as the cost to the taxpayer is concerned, the big bill is for bailing out AIG’s creditors. In his op-ed in the Wall Street Journal today, Lucian Bebchuk wants to know why.

Now, the government has not explicitly guaranteed AIG’s liabilities. But the main reason for bailing out AIG in the first place was the fear that an uncontrolled failure would have ripple effects that would take down many other financial institutions who were dependent in some way on AIG; most commonly, they had bought insurance, in the form of credit default swaps, from AIG and were counting on being paid. And a major usage of bailout money has been to make whole AIG’s counterparties holding those credit default swaps, primarily investment banks trading on their own account or on behalf of their hedge fund customers.

I still think it was a mistake to let Lehman fail, because of the sudden panic it created. But we are in a very different situation today. Many people now believe that the government may decide to let bank creditors lose some of their money. As Bebchuk says, instead of continually giving AIG taxpayer money that is effectively used to bail out other banks (many of which are in Europe, allowing European governments to free ride on the U.S.), the government could let AIG fail and bail out those other banks directly, thereby at least getting increased ownership stakes in return.

Bebchuck also explains that AIG’s insurance subsidiaries would not become insolvent if the AIG holding company went bankrupt, because they have their own reserves. (Insurance operations are regulated on a state-by-state basis, and state regulators establish reserve requirements for insurers.) Furthermore, he argues, failure is not an all-or-nothing proposition:

For example, the government could place AIG in Chapter 11, but commit to provide supplemental coverage that would make up any difference between the value that creditors would get from AIG’S reorganization and, say, an 80% recovery. Such an approach could allow setting different haircuts for different classes of creditors.
I think that the government could let AIG fail, if - and this is a big if - it can first identify which creditors and counterparties would be hurt, determine which of those cannot be allowed to fail (which should not be all of them), design a program to provide them enough capital directly, and announce everything on the same day. The net cost to the taxpayer cannot be higher than under the Too Big To Fail strategy, which implies a 100% guarantee for all counterparties and creditors (not to mention employees - bankruptcy would settle this whole question of whether the bonus contracts are legally binding once and for all).

There was clearly no time to do this between September 15 and September 16. But the government by now has had six months to study the books of AIG and its major domestic counterparties. People are no longer willing to take it on faith that the future of the free world depends on an implicit blanket guarantee for AIG. At least we want to see some evidence.

**Update:** Matthew Yglesias puts it very well.

I, for one, don’t think that “saving” the too-big-to-fail financial institutions is or was among the legitimate purposes of our financial policy. The idea is—or at least ought to be—that we’re trying to prevent them from failing *in a way that causes everyone else’s business to go under.*

(Yglesias also has just given me a massive insecurity complex, since he’s written nine posts so far today. I also liked this one.)

**Update 2:** I wish I had read James Hamilton earlier. Here’s the bottom line:

I accept the argument that a complete failure of AIG would have unacceptable consequences. The relevant question then is, what combination of parties is going to absorb the loss?

The concern I wish to raise is that any reasonable answer to that question would include Goldman Sachs, Merrill Lynch, Societe Generale, and Calyon, to pick a few names at random, as major contributors to this particular collateral-damage-minimization relief fund. But if they are to contribute, the plan must be something other than doling out another $100 billion every few months to try to keep the operation going a little longer, but instead requires seizing this bull by the horns. Split AIG into a core business we want to protect— with enough equity to be a viable operation, and a hefty fraction of the existing management team fired— and a derivatives business that’s going to be systematically liquidated in large part by abrogation of outstanding contracts.

*By James Kwak*
Mar 20, 2009 9:06 AM

Parallel Bankers

from The Baseline Scenario by Simon Johnson

AIG is arguing that its people are uniquely qualified to clean up the mess they made and therefore need big retention payments.

Of course, there are many things that are different and complex about this crisis in general and credit default swaps in particular. But in every crisis I’ve ever seen, the (banking/corporate/government) insiders responsible for major problems always want to stay on - arguing that they have unique skills and can sort things out better than anyone else. Countless times around the world I’ve heard some version of, “it’s very complex, no one else can figure it out, and you’ll lose a lot more money unless you keep us on.”

Yet, whenever possible, it’s better to clean house and bring in new talent at all levels to wind down bad business and more generally clean up/recapitalize/reprivatize the financial sector.

In the New York Times print edition (p.A25) this morning and online, James and I elaborate on why this is - drawing particular parallels with the Asian crisis of the late 1990s.

By Simon Johnson

Mar 19, 2009 1:34 PM

Protesting the Banks

from The Baseline Scenario by James Kwak
In the past, several of our readers have asked if we could help organize some sort of popular political movement to protest some of the policies that we have criticized. That isn’t anything we have any experience or expertise in, however. But in case you are interested, I wanted to let you know about a new group called A New Way Forward that is organizing rallies on April 11. Their platform is pretty straightforward:

**NATIONALIZE:** Experts agree — Insolvent banks that are too big to fail must incur a temporary FDIC intervention - no more blank check taxpayer handouts.

**REORGANIZE:** Current CEOs and board members must be removed and bonuses wiped out. The financial elite must share in the cost of what they have caused.

**DECENTRALIZE:** Banks must be broken up and sold back to the private market with new antitrust rules in place—new banks, managed by new people. Any bank that’s “too big to fail” means that it’s too big for a free market to function.

A New Way Forward is being organized by two people from the Participatory Politics Foundation, although the two groups are not officially related.

*By James Kwak*

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Mar 19, 2009 9:57 AM

**Causes Of A Great Inflation: Tunneling For Resurrection**

from The Baseline Scenario by Simon Johnson

Here is Ben Bernanke’s problem.

1. The financial sector is busy setting up arrangements in which employees are guaranteed high levels of compensation if they stay on through the difficult days ahead. These retention-type payments allow firms to survive in their existing form, pursue business-as-usual, and gamble for resurrection, i.e., make further risky investments.
2. But these same payment schemes, e.g., Goldman Sachs’ loans-for-employees deal, are a form of poison pill with regard to further bailouts - the Administration may want to help these firms down the road, but this kind of tunneling means Congress will put its foot down. Do you think that President Obama’s $750bn for bailouts (scored as $250bn) will survive the budget process? No New Bailout Money is a slogan reaching from here to the midterm congressional elections.

3. And the financial system is in big trouble. Unless the economy turns around, somewhat miraculously, we are in for a big slump. Or even for a Great Depression - watch closely the words and body language in Bernanke’s interview on 60 Minutes.

The big banks are essentially making themselves Too Politically Toxic To Rescue, and this has potentially bad macroeconomic consequences. So what will Bernanke do?

As he sees the world, there is only one course of action remaining: print money and hope for a moderate degree of inflation. The money part was, of course, the announcement yesterday from the Fed.

The inflation part is a leap of faith. If inflation is driven by the so-called “output gap,” i.e., how far the US economy is below potential output, then prices will not increase much, the yield curve steepens moderately, and banks make out like bandits (it’s just an expression).

But if the whole world is moving more into an emerging market-type situation then (a) inflation expectations become deanchored (central bank jargon for “really scary”), (b) potential output falls as we massively deleverage, and (b) people move increasingly into alternative assets - storable commodities spring to mind - and we get some serious inflation.

If oil prices jump, then we have an even bigger inflation problem. Oil is not storable, supposedly. But if you can explain to me exactly why oil prices rose as they did during the first part of 2008, despite the slowing global economy, I might be greatly reassured that we are not heading immediately into a runaway inflation spiral.

By Simon Johnson

Mar 19, 2009 9:57 AM

Blog Housekeeping
from The Baseline Scenario by James Kwak

Twitter

We are going to start experimenting with Twitter. I’m not sure how we’re going to use it, but our handle is baselinescene and you can find it here. Simon and I are sharing one account and, if we remember, will put our initials at the end of updates so you can tell who is who. We will probably use it to announce new posts (but probably not all of them, since right now I don’t know how to do it automatically), link to articles we find interesting but don’t have time to blog about, and broadcast random thoughts about the economy. (Don’t expect to find what we ate for lunch - unless it’s really good.) If this doesn’t turn into something useful, we’ll stop using it.

I’m not going to explain what Twitter is and how to use it, because I don’t really know. If you don’t know and you’re curious, ask someone under the age of 30.

Update: Thanks to the reader who pointed out twitterfeed, our new blog posts are now automatically added to our Twitter updates.

Also, for those who may be worried: If you ignore Twitter, you won’t be losing out on anything important; there’s nothing we do on the blog today that we are moving to Twitter.

Email updates

Several people have pointed out that our automated email updates do not include the name of the author for each post. This is a problem with Feedburner (the service we use to generate and send these updates) and there is no known solution.* So we have decided to start manually adding our names at the end of posts from now on. Since this is manual, we may forget from time to time; you can always find out who the author is by visiting the post itself on the web.

* We can’t use FeedFlares because we use WordPress.com, which doesn’t allow Javascript.

By James Kwak

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Mar 18, 2009 8:47 AM
Baseline Blocking

from The Baseline Scenario by Simon Johnson

A reader reports his firm has blocked Internet access to BaselineScenario.com, and his requests to change this policy have so far gone unheeded.

Access to our site has been blocked in the past by China - for reasons that should be obvious (if you want to pretend there is no global crisis). But what kind of firm would not want its employees to access our macroeconomic analysis, Financial Crisis for Beginners, or your continuing debate about how to handle the world’s myriad financial sector problems?

Oh, yes…

Morgan Stanley.

No doubt there is a simple and reasonable explanation that has nothing to do with our views on banks, their executives, and the political power of the financial sector. And it must be pure coincidence that Morgan Stanley was mentioned in a less than completely positive light during my February interview with Bill Moyers.

Other websites and blogs are routinely blocked by Morgan Stanley, and it surely makes sense for any firm to be careful about what its employees can look at during working hours or over the corporate network. Still, here are the categories of sites that the firm explicitly blocks - which one includes us (or your comments)?

Abused Drugs

Adult Material

Freeware and Software Download

Gambling

Hacking

Illegal or Questionable

Instant Messaging Internet Communication

Keyloggers
Malicious Web Sites
Military & Extremist
Peer-to-Peer File Sharing
Personal Network Storage and Backup
Personals and Dating
Phishing & Other Frauds
Proxy Avoidance
Racism & Hate
Social Networking and Personal Sites
Spyware
Tasteless
URL Translation Sites
Violence
Web Chat
Web-based Email

Update: This is James. In the interests of fairness to Morgan Stanley... There is one comment below from a Morgan Stanley employee who says that access to this blog is intermittent. There is also another comment from an MS employee on Seeking Alpha’s rebroadcast of this post saying that he or she can read the site. So it’s not clear if the blocking is according to policy or is some sort of IT glitch.
The G20 needs a deal. It doesn’t make much sense to pull 20+ global leaders together on April 2nd unless you can announce an agreement with some bearing on the current worldwide slump. One more meaningless communique might not go down well with the markets. You can always trot out the same platitudes, but the world’s best journalists will be in attendance and it would be much better to have something concrete on display.

Time is running out for the deal makers. There appear to be no grounds for the US and Europe coming together in a meaningful way on fiscal policy: the US want everyone to commit to some (universal?) target; the Europeans either really don’t want that (Germany) or rightly feel they can’t afford it (most of the rest of the EU). Regulatory agendas intersect but only at the general level of, “we should do better” and ”it was your banks that got us here” - the AIG counterparties list make it clear that already-regulated large institutions in both the US and Europe are the problem. And the US Administration is waiting for Congress on regulation - this will take 6 months or more to sort out.

All of which leaves one main item around which there can be convergence: the IMF. And for this, China’s exchange rate is the issue.

The US has taken the initiative with Secretary Geithner’s proposal that IMF resources be increased by $500bn (i.e., from $250bn to $750bn) through a large loan from member countries. A loan of this scale has the advantage of providing sufficient support for the Fund over the next 12 months (unless the eurozone takes a major nosedive), while it doesn’t require the long drawn-out negotiation needed to change the Fund’s underlying quotas - the equity/voting structure of the organization is contentious because emerging markets demand more voice, while smaller European countries strongly resist reductions in their (overrepresented) voices.

Last weekend the Europeans rebuffed the Americans on the scale of this loan - preferring to stick with the IMF’s idea of “just” doubling its resources, i.e., an increase of $250bn. Of this, the Japanese already offered $100bn (in fact, this loan to the Fund is already in place). But in communique pledge math you can count contributions multiple times - come up with another $150bn from around the world and you can claim the $250bn headline.

In principle, this should not be difficult. In a world of trillion dollar problems, providing some tens of billions of dollars to prevent chaotic domino effects in emerging markets seems like a reasonable investment. And - here’s a key point - you are only providing the IMF with a line of credit, typically from your central bank, so the budgetary cost is basically zero and the opportunity cost is (a) minimal if you are holding a large amount of foreign exchange reserves,
(b) definitely zero if you are a reserve currency country, so your loan is in your own money (which you get to issue.)

So why not just put the US down for $40bn, the EU for $40bn, and China for $40bn - presuming you can put the Saudis down for $30bn? Not so fast says Capitol Hill - the Administration needs to request an authorization, and this requires a serious conversation. Still, that’s not too difficult in the current context, particularly if the world is waiting for a formal US answer after the summit and the current level of world trade hangs by a pretty thin thread.

Not so fast or not at all is also the gut reaction of the Germans, who like to think of the IMF as being even more austere than themselves. Of course, their attitude of “responsibility” looks increasingly irresponsible - what was the point of pushing hard for massive cuts in scarce experienced IMF staff right during the worst economic collapse in living memory? At this point, other Europeans can probably bring the Germans along, particularly as East-Central Europe stumbles towards further devaluations (tending, other things equal, to move jobs eastwards) and as Europeans all realize - stunning though this may seem - that the only idea they have for weak eurozone countries is to send them to the IMF for loans.

But can you get $40bn from China? Yes, if you are willing to do a deal. What do the Chinese want? Some commitment to further “reform” at the IMF (code for: more votes for China). The US can do this - because they will keep their veto at the IMF, which is all they really want. The small (in every sense) Europeans may choke on this, but they increasingly feel the need for China’s commitment to the Fund. So, the Chinese suggest, if you can’t promise immediate change at the Fund, here is another proposal: stop talking about China’s exchange rate.

China’s exchange rate has, since 2003, been substantially undervalued and China has - unambiguously - intervened to keep it that way. This has contributed to a massive current account surplus (over 10% of GDP) and a capital outflow (hence China’s currently reserve level of around $2trn) that has contravened the spirit of what large countries are supposed to do and - since a rules change at the IMF in summer 2007 - the letter of its international agreements. The IMF has, for moderately inexplicable reasons, not yet been able to call China to account; this increasingly grates on Congress, as it should.

So now China proposes: hush money. Take complaints about the renminbi off the table, and you can have a big loan. And shut up already about how global imbalances (code for: China’s surplus) contributed to the easy funding environment that fed the latter phases of the global debt boom. It’s awkward, given the frequency with which policymakers like to blame the “global savings glut” (code for: China’s high savings/current account surplus, mostly), but this is mostly about deleting a paragraph or two from standard speeches.

Is it worth it? Would this lead to more or less pressure for protectionism in the US and Europe? If China devalues further, to take the edge off its recession, would that also be OK?

They’ll work hard to do this deal, or some version of it, in the run up to April 2nd. Whether it turns out to be a good idea remains to be seen.
The Tipping Point?

from The Baseline Scenario by James Kwak

$165 million, of course, is less than one-tenth of one percent of the total amount of bailout money given to AIG in one form or another. Yet it may turn out to be the $165 million that broke the camel’s back.

The AIG bonus saga neatly encapsulates many of the problems that we have identified with the financial system and with the bailout to date.

• The bonus contracts - which have still not been released to the public - reflect the instinct of Wall Street to favor its employees over any other stakeholders. In the companies I worked at, it was common practice that all bonus plans were contingent on overall company performance: if the company had no money, you didn’t get any, either. Even our commission plans for sales people included the caveat that the plan could be changed by the CEO at any time for any reason. The fact that AIG did not similarly protect itself shows the Wall Street habit of putting itself first, or a failure to recognize the possibility of a bad year, or, most likely, both.

• The failure of the Treasury Department and the Federal Reserve to review and renegotiate the bonus plans as a condition of federal assistance last fall - despite the fact that the plans had been public knowledge since May - reflects the rushed, ad hoc nature of the deals that were struck. Or it reflects the understanding in Washington that the ways of Wall Street had to be respected. Or, again, both. And the failure to even say anything about the bonus plans since the initial bailout - even just to get ahead of the obvious public relations fiasco - reflects an overall strategy that amounts to hoping that problems will go away.

• The seeming inability of the government to do anything but throw up its hands reflects the failed strategy of the bailouts so far: provide as much cash as needed, but do everything you can to minimize the impact on the companies being bailed out. The fact
that this is happening at AIG - the one the government has owned 80% of since September - shows that any “nationalization” so far has been a red herring. In a bankruptcy, or a government conservatorship, employees and other creditors would not have a legal right to all of their money. In the current situation, by contrast, AIG management can choose whom it wants to make whole, which is what makes self-dealing and other sweetheart deals possible. In this context, $165 million in employee bonuses pales against tens of billions of dollars of collateral provided to counterparties - beginning with Goldman Sachs. Yes, this was to cover open trading positions. But if AIG had gone bankrupt or had been taken over, it’s not clear that Goldman would have been first in line.

- The testimonials to “the best and the brightest” - here, referring to the people of AIG Financial Products - reflect, I don’t know, either absolute, brazen obscenity, or a world-historical example of making the mistake of believing your own hype. The fact that people on Wall Street believe that they are the best among us is bad enough. The fact that people in Washington are willing to accept it is worse.

However, this scandal may yet serve a purpose. One characteristic of both administrations’ responses to the crisis has been to devise subsidies for the financial sector that are too complicated for even conscientious readers to make out, such as the asset guarantees for Citigroup and Bank of America, or the preferred-to-common conversion for Citigroup. Employee bonuses, by contrast, are strikingly easy to understand.

The key issues throughout this crisis have been political as much as economic. In this case, the Obama administration has been taking a difficult political position - propping up financial institutions in their current form and insisting everything will be OK - when it would have been easier to play the populist card. This was by no means an inescapable choice; according to news reports in February, David Axelrod and Rahm Emmanuel were in favor of being tougher on the banks. Perhaps the AIG bonus scandal will force the administration’s hand toward the decisive action that we need.
Adam Davidson at Planet Money recently asked, “Who Do We Blame?” Which, I think, is a perfectly legitimate question. While the most important things are getting ourselves out of this crisis and reducing the chances of another one happening, asking who is at fault for this one is a reasonable exercise, for at least two reasons: first, it responds to our basic human curiosity; second, since many of the parties involved care only about their reputations (Bush, Clinton, Greenspan, Paulson, etc. have enough money for several lifetimes), going after people’s reputations is one of the few ways to create some measure of accountability. Politicians who inveigh against “pointing fingers” usually have something to hide.

I started writing a comment on the Planet Money thread, but they have a character limit on comments, and it’s hard for me to write anything in fewer than 1250 characters. So I emailed them my response and, what do you know, they put it up as a post on their blog. To save you any suspense, I think that if you are going to blame any individual (as opposed to, say, a whole category of activity, like “lax loan underwriting”), it should be Alan Greenspan, for reasons described further in that post.

**Update:** My friend Dave Sohigian blames an entire generation.

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Mar 17, 2009 11:19 AM

**Nationalization and Democracy**

from The Baseline Scenario by James Kwak

More extra-credit reading while on spring break: Sanjiv Gupta has an article at The Huffington Post about the relationship between the financial crisis, our banking sector, and democracy. The central question, as I see it, is an old one: how to ensure that a democratic political system is not undermined by a non-democratic economic system. Gupta suggests, as one possible step, a national credit union to compete with private-sector banks. To think about this in detail, we’d have to think about why we (most of us, including me) instinctively think that the following the profit motive is generally the right way to allocate capital. That’s something I hope to devote more space to later.
Stabilization programs in emerging markets often come down to this: the government needs to do something unpopular, e.g., reduce some subsidies, privatize an industry, or eliminate the crazy credit that goes to oligarchs - no one likes oligarchs, but their factories employ a lot of people. There is naturally resistance - pushback from legislators, riots in the streets, or oligarchs calling their friends in the US foreign policy establishment. The question becomes: does the government have the “political will” to get the job done?

In fall 1997, a key issue for Indonesia’s IMF program was whether the government could close the banking operations belonging to one of President Suharto’s sons. There was an epic and fascinating struggle and, in the end, the government did not have sufficient political will or power. The subsequent loss of US support, and further currency and economic collapse is (messy and painful for many) history.

It is striking that Ben Bernanke now asks whether the United States today has sufficient political will.

How did we get to the point where the U.S., with a strong balance sheet relative to the size of problem banks, is regarded - by the markets and more broadly - as less likely to resolve the problems in its financial system than say the British (with big banks relative to a weak fiscal position) or the Germans (who talk all the time about how they are not going to bail anyone out)?

You can point the finger at Congress. The parliamentary system in Britain and Germany means that the government can implement and innovate a bailout policy without worrying about being able to legislate enough financial support. The Obama Administration has much to worry about in this regard.
The problem surely goes deeper - at least back to the bailouts of the fall. Poor communication, particularly by Hank Paulson, undermined popular and congressional support. And the lack of a consistent strategy exacerbated initially negative perceptions.

But the underlying issues are deeper still and laid bare by this week’s latest round with AIG. We have moved far beyond financial policy and into the kind of scandal that really gets taxpayers’ backs up. The greed of bankers slaps you in the face while the hubris of their leadership remains unchecked.

There is no sense of responsibility, no feeling of shame, no acknowledgment of any kind of mistake: read Lloyd Blankfein’s FT article again - or print it out and tape it to your wall. Because we now know, from the newly disclosed AIG counterparties list, that the wealth of Goldman Sachs insiders remains high solely because we saved their sorry bank, their failed risk management strategy, and their pretense of wisdom with our cash in mid-September.

This resentment against bankers pervades Congress, and even the Administration begins to get the message - being called “asinine” yesterday by Richard Kovacevich, the Chairman of Wells Fargo, may have helped underline to Treasury how deeply the bankers appreciate the help they have received. There can be no resolution and no moving on until there has been a proper congressional investigation, with full subpoena powers, into exactly what did and did not happen around AIG. This will take months and may well slow down the economy (Jamie Dimon’s clever point: if you vilify us, you will lose), but it is now inescapable. And, if channeled productively, this kind of hearing may lead to a better regulatory system (and smaller big banks) than the current anemic proposals on the table - as last weekend indicated, the G20 process is currently worse than useless on this issue.

Ben Bernanke knows all this, at the same time as he sees our economy worsening and global storm clouds still gathering. So where will he take us, starting with the Federal Open Market Committee meeting this week? The British experiment with quantitative easing is pushing down the yield on long government debt. It’s risky - inflation, once started, is not so easy to control. And it may not work so well in the US (where the dollar tends to appreciate as the world becomes more scary) as in the UK (where they can successfully push for depreciation, particularly vis-a-vis the hidebound eurozone).

Inflation breaks the political and social logjam around banking. With some luck, it helps growth - at least in the short-term. And of course the surviving bankers win big.

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Mar 16, 2009 6:25 AM
A fundamental principle that we all hold dear is: in industrialized countries, with relatively high income levels, the government can’t be completely out to lunch. After all, we reason, there are democratic processes, watchdogs of various kinds, and we can safely delegate monitoring of government official actions to others (e.g., the media).

This principle is, of course, now appropriately called into question both for government officials directly and increasingly for the media’s scrutiny of what the government (and business) is doing. As a result, the level of public attention to various domestic policies - bailouts and the like - is surely at or close to all-time highs; the current reaction time and seriousness in public discussions of various initiatives for banks must set some sort of record.

Yet there remains at least one completely murky and unaccountable area of government action: international economic diplomacy.

The G20 summit, broadly, is a leading example (as is the G20 process since the fall). No one can believe that this really achieved nothing because that would be, well, dumb. And we know our rulers are not stupid.

But smart people frequently produce unfortunate or even idiotic outcomes - it all depends on the incentives and the process. And, of course, of their ability to keep things covered up until they have moved on to another job. Check with your local subprime mortgage lender for details.

As a leading example of what you can get away with in the international economic diplomacy space, I would emphasize how key European governments (France and Germany, also the UK to a large degree; the EU and others tag along) are currently viewing the issue of resources for the IMF - and I would link this to how they and the previous U.S. Administration treated the IMF’s staff and capability more generally. From my op ed in The New Republic on-line this morning (I’ll post the link below when it goes live),

The only slight ray of hope [from the G20 process at present] is the American idea to increase funding dramatically for the International Monetary Fund. In addition to enabling the Fund to help emerging markets as they increasingly fall into the danger zone, it should provide a backstop for the eurozone—in case France and Germany fail to provide it themselves.

Yet even on this dimension, the news on Saturday was bad. Secretary Tim Geithner this week proposed an additional $500 billion for the IMF—this would constitute a bold and long overdue tripling of its loanable resources. But the West Europeans are, inexplicably, digging in around the idea that there should be only another $250 billion for the Fund (and they haven’t actually
offered to pay anything themselves). Providing these resources has no budgetary implications and no other financial costs for the countries that choose to hold their reserves partly as a line of credit to the IMF. Without significant money for the IMF from European countries with deep pockets, though, there is no hope of attracting large-scale resources from emerging markets. And if the IMF is short of funds, it has no alternative but to negotiate tougher lending programs with countries that need external financial assistance. To you and me, the implications are simple and stark: a longer recession and a more difficult recovery. So why not do it?

It is, pure and simple, the kind of short-sighted and deluded European financial policy that prompted leading countries to demand that the IMF cut 20 percent of its most skilled and experienced personnel in early 2008—at the same time as Bear Stearns collapsed and major banks in almost all industrial countries started to unravel. It is hardly believable—but nevertheless true—that the G7 and now the G20 have refused to undo the IMF cuts and replace essential staff.

Yes, European leaders and the Bush Administration pushed hard for the IMF to cut back on skilled and experienced staff just as the global crisis broke—and as the IMF was emphasizing, politely in public and pointedly in private, that this was a major crisis likely affecting all countries. In fact, given that this emphasis was not welcome by governments, this apparently hardened the resolve of key players to push through senseless, unnecessary, and irresponsible cuts.

Egregious stupidity and borderline malpractice goes unnoticed in the international economic diplomacy space, or at least not picked up on by leading news sources or in the general public discussion. Why? To some (the media), it doesn’t quite meet the threshold for newsworthy—it’s a little too far from the interests of readers and a bit too hard to explain in a news program; nobody cares as much about international issues as they do about domestic bailout scandals—for which there is a much higher tolerance for compelling details. To others (much of the public), it seems too technical and surely something best left to experts. And—remarkably and mistakenly—those who follow the IMF closely (e.g., in the development community) think that this downsizing somehow fits with what they have been trying to achieve; they were completely snowed.

European policy towards the IMF is a masterpiece of misdirection and disinformation. The proportions and audacity should take your breath away. And of course the same principle applies to government officials dealing with international economic policy as it does to CEOs of failing banks: never admit responsibility and definitely never suggest there was the slightest mistake in the past (because that might actually be newsworthy to the mainstream or, even more scary, draw Jon Stewart’s attention).

Rearranging the deck chairs on the Titanic looks productive by comparison. The actions of the G7 with regard to the IMF in 2008—and the attitudes of the Europeans still today—are more like burning lifeboats and throwing skilled pilots overboard. In this context, what are the odds that the upcoming G20 heads of government summit on April 2nd will truly be productive?
Mar 14, 2009 11:43 PM

**The G20 Lets Us Down**

from *The Baseline Scenario* by Simon Johnson

I’m continually amazed by how easy it is for government officials to hoodwink most of the news media. All it takes is for a couple of leading finance ministers to get on roughly the same page, and we’re reading/hearing about “substantial progress” or “major steps forward.” If someone provides an articulate background briefing to a leading newspaper on the supposed debate within a group of countries, this becomes the dominant news story.

Saturday’s G20 meeting of finance ministers and central bank governors is a leading example. It was a disaster - we face what officials readily concede is the biggest financial and economic crisis since the 1930s, yet this conclave agreed precisely nothing that will make any difference. If the G20 heads of government summit on April 2nd is a similar failure, we will be staring at the real possibility of a global catastrophe. Yet the spinning storytellers of the G7 have still managed to get much of the press peering in entirely the wrong direction.

For more on what would the right direction, take a look at my piece in Britain’s Sunday Telegraph.

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Mar 14, 2009 11:43 PM

**Spring Break**
My school is on break this week, so I’m taking some time off from now through Wednesday or Thursday. I probably won’t write anything very involved, but I will try to point out a few things I’ve been reading.

On that note, I finally read Amartya Sen’s essay “Capitalism in Crisis” from The New York Review of Books. The article meanders through a variety of topics, but two of the broad themes are: the economic systems we call “capitalist” involve much more intertwining of free markets and nonmarket goods and services (education, health care, pensions, etc.) than most people realize; and we need less to invent a new form of capitalism than to understand better the one we already have.

This is my last post on nationalization for at least a week, and hopefully a lot longer than that. I’m tired of writing about it. But I was listening to Raghuram Rajan on Planet Money, and things became a little more clear to me.

Rajan was saying that he had some concerns about nationalization and didn’t think it was necessary to fix the banking system. His concerns were sensible, I have counter-arguments for them, and I don’t want to get into a detailed debate here. More importantly, he agreed with the nationalizers that the system is broken, hasn’t been fixed, and needs to be fixed - he just thinks you could do it a different way.

We’ve talked and talked about it but never actually taken action. We need to take some of the bad assets off the balance sheet. We need to recapitalize the banks to the extent that is needed after that, and that might mean more and more government ownership, that’s a possibility. . . .

The real issue is the taxpayer, unfortunately, has to put more money into the system; hopefully much of it will be recovered. He has to put more money in in the short run, both in buying these assets off balance sheets, and recapitalizing the banks, so that the banks then have clean enough
balance sheets such that they will begin to lend when the system recovers... If you can clean up the system, my sense is whether you call it nationalization, or call it cleaning up by putting more money without nationalizing, cleaning up is the first-order thing.

I think there are three main positions in this debate:

- **A1**: The banking system is broken. Banks need to get rid of their toxic assets and they need more capital. The solution is for the government to buy their toxic assets at a high price (or insure those assets) and to give them lots of cheap capital.

- **A2**: The banking system is broken. Banks need to get rid of their toxic assets and they need more capital. The solution is for the government to take them over, transfer off their toxic assets, recapitalize them, and (when possible) sell them back into the private sector.

- **B**: The banking system is basically sound and will recover if we give it some time. In the meantime, the government should give the banks just enough money and intervene as little as possible to keep them afloat until asset prices recover.

The big divide is not between A1 (Rajan) and A2 (Simon and me). In both cases, you end up with a healthy banking system, at significant taxpayer expense. (A2 should be somewhat cheaper because it wipes out the shareholders, but I agree with Rajan that it is dramatically cheaper only if the government is willing to restructure some of the liabilities.)

The big divide is between both of these and B, the position of the Bush and Obama administrations - both of which rejected aggressive measures in favor of just-in-time, just-big-enough bailouts. Now the government is conducting stress tests on an industry it has already said is adequately capitalized, and will follow that with a public-private asset-buying program that tries to split the difference between paying real market value and paying enough to keep the banks happy. I’ve quoted these exact words before, but here’s Krugman again: “The actual plan seems to be to keep the banks semi-alive by implicitly guaranteeing their liabilities and dribbling in money as necessary, all the while proclaiming that they’re adequately capitalized — and hope that things turn up.”

Now, let’s say you agree that something more needs to be done. Then you have to choose between A1 and A2. A2 is the one people typically call “nationalization.” But which is more consistent with a capitalist system: protecting the creditors who lent money to a failed bank, the shareholders who invested in a failed bank, and the managers who failed... or firing the managers, wiping out the shareholders, and maybe, if possible without triggering collateral damage, forcing some of the creditors to take some losses? Which one better approximates the incentives you want in a free market?
Reining In Banks (Roundtable On Economist.Com)

from The Baseline Scenario by Simon Johnson

The Economist is running an on-line discussion of Dani Rodrik’s article in their print edition on re-regulation strategy. The full discussion is here - follow that link for my contribution, the reactions of others, and Dani’s original piece.

Here’s what I said.

Dani Rodrik is right that good financial regulation begins and pretty much ends at home. Attempts to build a global regulatory structure, for example as currently under discussion by the G20, seem unlikely seriously constrain the ability of big banks to get themselves - and the rest of us - into major financial disasters.

These big banks are very powerful, exerting a great deal of political influence in the United States and arguably even more in some other industrialized countries. The U.S. bristles at potentially critical footnotes in IMF documents assessing its macroeconomic policies - how would it react to tough language or even real action from an international body that claimed supervisory authority over American banks?

The strong position of the U.S. vis-à-vis the International Monetary Fund (IMF) has, for a long time, been an awkward reminder that all members of the IMF are not created equal. But of late, with deep flaws in the heart of the world’s largest financial system, the asymmetry of international power and lack of effective oversight over the U.S. is actually dangerous for the world economy. There is no global solution to this very American problem.

The only way forward is to dramatically change the effectiveness of regulation in the U.S. But this will not happen primarily through tweaking de jure rules or attempting to create one regulator with responsibility for the whole system - whether or not this is the Federal Reserve. Again, the banks have too much power - they will capture, influence, or arbitrage their way around any regulatory structures so that the next bubble, whenever and wherever it appears, will be at least as damaging as the last.

We need to break or substantially reduce the political power of the banks in the U.S. and in all other countries where this is a pressing first-order issue. This is a tall order, but if the problems gain sufficient visibility and our political leaders focus, we can make progress.
Mar 13, 2009 12:00 AM

**Business As Usual**

from *The Baseline Scenario* by Simon Johnson

If you think that the power of the banking industry may be in decline, or that its leaders are humbled, or that any kind of major change is underway, please review carefully Jamie Dimon’s speech from Wednesday, March 11 ([available on Bloomberg.com](http://www.bloomberg.com)).

Mr. Dimon, who runs JP Morgan Chase, makes it clear that he has great respect and appreciation for all that Hank Paulson did for the financial sector. He also strongly implies that it is time for the government to stop worrying about what approach to adopt; as far as he is concerned, the **time for wrangling and figuring out what went wrong is over** and the time for really big transfers of taxpayer value is now.

There is no sense here that anything much has changed. Sure, we’ve lost some banks, we’re in a big recession, and everything we thought sensible for banks in terms of regulation/risk management/corporate governance lies in tatters. But it is obvious, from the words, tone, and body language of Mr. Dimon that he thinks his side has won and it is back to business as usual, albeit now with a somewhat larger market share. On all of this, he probably has inside information.

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Mar 12, 2009 4:13 PM

**Bernie Madoff Day**

from *The Baseline Scenario* by James Kwak

As Bernie Madoff **goes to his reward** today, we should be asking how this could have happened. Not only Madoff and Allen Stanford, but also dozens of “**mini-Madoiffs**” have been unearthed since the market collapse in September and October, which seems to have reminded the SEC that it has an law enforcement function. Not surprisingly, regulators are ramping up their
enforcement divisions, and Congressmen are planning legislation to increase enforcement budgets.

A little late to close the barn door.

While Christopher Cox, SEC chairman from 2005 until this January, makes an obvious target, there is a deeper phenomenon at work than just the Bush administration’s hands-off attitude toward corporate fraud (an attitude largely shared by the Clinton administration). That is the general tendency of people - investors and officials alike - to underestimate the risk of fraud during a boom and overestimate the risk of fraud during a bust.

This issue is discussed in a paper by Amitai Aviram published in my own school’s Yale Journal on Regulation (but since you can’t get it from their website, get it from SSRN).

Aviram’s first point is that people tend to ignore fraud risk in good times and worry about it in bad times. There are many reasons for this. Falling asset values and credit crunches make it harder to perpetuate certain types of fraud, such as Ponzi schemes, but there are other factors. In one form of cognitive bias, people ascribe good outcomes to their own investing “skill,” and bad outcomes to exogenous factors they cannot be blamed for, such as fraud. The discovery of a few well-publicized instances of fraud creates an availability bias, where people miscalculate the incidence of fraud.

Typical enforcement patterns only exacerbate this cycle. According to Aviram, the traditional academic model of enforcement is that you set a budget such that, at the margin, the marginal cost of enforcement equals the marginal benefit of enforcement. In practice, however, this model is affected by political pressures. In a boom, when the public underestimates the risk of fraud, there is no percentage in presenting yourself as a crusader against big corporations or Wall Street - especially when they are being portrayed in the media as heroes, as Enron was prior to 2001. But in a bust, the way to score political points is to go after the “crooks and robbers,” which is especially convenient after they have been pointed out to you by the markets (Enron, Madoff). This leads to underenforcement during the boom and overenforcement during the bust. (Or, I might say, severe underenforcement during the boom and maybe sufficient enforcement during the bust.)

Here’s what this looks like:
That’s the annual percent change in the S&P 500 plotted against the annual percent change in the number of SEC enforcement actions. I would have liked to see a regression, or at least a correlation, but this is a law paper, after all.

So, yes, it’s the fault of regulators who are too soft on industry, but they also share the misperceptions of the public at large, which wants to believe that everything is just fine when the market is going up. Of course, regulators are supposed to know more than the public at large.

Aviram has a discussion of the role of conspicuous law enforcement itself in reinforcing or counteracting these misperceptions. This discussion is wishy-washy, because he leaves open the question of whether conspicuous law enforcement increases or decreases risk perceptions. (Again, this is a law paper - no equations and few numbers, just concepts.) But I think it’s pretty clear that it decreases risk perceptions. Let’s put it this way: On the day that you learned about Bernie Madoff, did you feel more secure because you felt like the SEC was doing a good job protecting you? Or did you feel less secure because if Madoff could get away with it for so long, who else could? Let’s assume I’m right and then follow Aviram’s reasoning. In that case, this cyclical enforcement pattern makes things even worse, because the lack of enforcement during good times makes people feel even more secure, and the “over” enforcement in bad times makes them even more paranoid. Therefore, he concludes, enforcement should be expressly counter-cyclical, which requires insulating the regulators from public pressure to be lax during a boom.

Thus, when conspicuous law enforcement increases risk perception [my assumption], implementing the correct long-term policy will cause fear and anger among the public in the short term. Nonetheless, if the goal of anti-fraud laws is to maximize long term efficiency, the public’s immediate sentiments should not be a consideration for abandoning the optimal (long-
term) policy. In fact, the law enforcer should be shielded from precisely these short-term pressures.

Aviram cites central banks as an example of an institution that is appropriately counter-cyclical. But let’s not fault him for that. The paper was first written in early 2007, and few people could have foreseen what happened since. Indeed, the implicit prediction that we would see a blossoming of enforcement energy in a market bust - after most of the damage has been done - turns out to have been dead-on.

from The Baseline Scenario by Simon Johnson

This morning I testified before the House Foreign Relations Committee’s Subcommittee on Terrorism, Nonproliferation, and Trade.

My written testimony is available through the Peterson Institute for International Economics’ website. I was asked to provide a perspective on the global economic outlook, so my testimony previews our next Baseline - we’ll release that when we see the G20 outcomes (i.e., from ministers of finance and central bank governors) this weekend.

In my interactions with the committee members, I stressed three points that connect our view of the outlook with the upcoming G20 discussions this weekend.

1. The financial sector should be thought of at this stage as a type of undefused bomb. We might be able to live with it for years or it could be a more immediate issue. There is nothing I see in anyone’s G20 agenda that even begins to address this; the “regulation” pieces proposed by Europe will make essentially no productive progress in the right direction.

2. The financial problem is much worse in Europe than in the United States, because (a) banks are larger relative to GDP in Europe, and (b) they have major problems with bad loans (from US property, European property, East European property and more). We have banks that can claim to be Too Big To Fail. Europe has banks that may be Too Big To Rescue. Sadly, therefore, most European countries don’t have room for further fiscal stimulus - they need to prepare to help out their own bank depositors, as well as weaker EU and eurozone member countries; putting all available resources into a European Emergency Stabilization Fund should be the priority.
3. In this context, I support Secretary Geithner’s call yesterday for $500bn in additional resources for the IMF (i.e., they would go from being able to lend $250bn currently to potentially lending $750bn; I called for $1trn in the fall, so we are getting there). But this should be seen as the backstop in case the Europeans drop the ball, particularly for smaller eurozone countries. I don’t know how likely that is (ask me again after the weekend), but more money for the IMF is smart contingency planning - what else are you going to do?

In the broader discussion before the committee, what really struck me is how angry people are about our trading partners’ behavior (including China, but also Europe, Latin America, and other parts of Asia were mentioned). There may be some good specific reasons to be unhappy, but I worry about the fragility of global trading relationships under the pressure we face today.

Move over, Bill Moyers. * Simon is going to be on Stephen Colbert tonight.

If you have predictions about what Colbert is going to want to talk about, or ideas for witty comebacks, please post them. I believe Simon is traveling but will check in around 6 pm Eastern.

* Just kidding. Bill Moyers is one of our finest public servants.
A week ago, Simon wrote his “Confusion, Tunneling, and Looting” post, which argued that the confusion created by crises helps the powerful and well-positioned siphon assets out of institutions and out of the government. The revelations that much of the AIG bailout money has gone straight to its large bank counterparties in the form of collateral could fall under this heading.

The looting theme has gone mainstream, with David Leonhardt in The New York Times. I think Leonhardt’s article is good, but it describes looting (taking advantage of implicit government guarantees to take excessive risks) as a cause of the mess we are now in - and as something we’ll need to worry about in preventing crises in the future. But, as Simon argued, it’s also something to worry about right now. As long as the Too Big To Fail doctrine holds, the banks’ implicit government guarantee is more explicit than it ever has been. So whatever perverse incentives helped bring on the crisis are even stronger today.

But Are They Buying It?

from The Baseline Scenario by James Kwak

As Simon wrote this morning, the administration strategy is to wait and see if the economy turns around, lifting banks out of the mess they created. How can you tell if this is working? One way is to look at bank bonds.

If the administration is right and the banks are healthy (and to the extent they aren’t healthy, their capital will be topped up with convertible preferred shares), then bank bonds are safe. Even subordinated bonds (the ones that get paid off after senior bonds and insured deposits) are protected by the bank’s capital - both common and preferred shares. So if the administration is correct that the banking system is adequately capitalized, and will be even more adequately capitalized after the stress tests and capital infusions, then banks will be able to pay off all of their bonds.

Even if the administration is wrong and the banks are not adequately capitalized, bondholders are only in danger if the administration decides not to protect them. This could happen in one of two ways. First, the administration could request, as a condition of a future bailout, that bondholders exchange some of their debt for equity. There is no law that says that bondholders have to exchange their bonds for equity just because the government asks, so the threat would be that the government would not bail out the bank otherwise (forcing it into bankruptcy or
Second, the administration could take over the banks; in that case, the regulator might decide *not to pay back all of the bondholders* - but it certainly could decide to pay them back. It’s just a question of whether losses are borne by the bondholders or the taxpayer (assuming the equity holders have been wiped out).

So what does the bond market think?

According to a Bloomberg article this morning, the bond market is scared. Yields on bank debt overall are 3.6 percentage higher than for industrial companies (before August 2007 they were lower); Citigroup’s subordinated debt due in October 2010 has fallen from 95 cents to 77 cents on the dollar in the last three weeks; Bank of America’s subordinated debt due in January 2011 is down from 99 cents to 80 cents. Here is some color:

“The bond market is getting more scared every day,” said Gary Austin of PDR Advisors in Charlotte, North Carolina, who manages $450 million in fixed-income securities. “At some time, the government is going to say enough is enough, the only way we will give you more cash is if the bondholders have to be hit.” . . .

“The current prices imply that the companies’ equity is worthless, the government’s investment is worthless and subordinated debt holders will lose some of their investment,” said David Darst, an analyst at FTN Equity Capital Markets in Nashville, Tennessee.

In other words, the bond market isn’t buying the administration’s story, and thinks there’s a pretty hefty risk not only that some banks will be taken over, but that bondholders will be made to suffer in the process. Correct or not, this perception decreases confidence in the banking sector as a whole, because of the potential *ripple effects of shorting creditors*.

Maybe Treasury or the Fed will start buying subordinated bank bonds in order to project confidence. That would be putting its money where its mouth is. Of course, that would also guarantee that the taxpayer will suffer any potential losses, one way or the other.

* The government tried this with GMAC back in December, with only partial success. Some bondholders, including PIMCO, refused to convert, betting that the government would bail out GMAC anyway, which it obligingly did. Felix Salmon covered this extensively (short version and [long version](http://www.finsider.com/post/091103/graham.BindingSource b = (GrA_091225_110559). sınıfı olarak oluşturulum); (short version) and [long version](http://www.finsider.com/post/091103/graham.BindingSource b = (GrA_091225_110559). sınıfı olarak oluşturulum)). This means that the government may not be able to go the voluntary route in the future.

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Mar 11, 2009 6:31 AM

**That Worked (?)**
At last, our long wait to learn the Administration’s policy on banking is over. The policy is: wait.

This message comes from Bernanke, Geithner, and other officials over the past few days. And, in this season of attempted policy message convergence within the G7 (it happens or tries to happen twice a year, ahead of the IMF/World Bank ministerial meetings), it is what we are starting to hear on all sides (e.g., from Trichet, head of the European Central Bank): we’ve done a lot, our economies might recover, and we don’t want to overdo it. So we’ll wait.

Looking just at the US economy or just at the Eurozone, this might make sense. But recognizing at what is heading our way from Eastern Europe and other rapidly slowing parts of the global economy, “the risks are weighted to the downside” (an official euphemism that you will hear frequently in the coming weeks). And the market is not so easily convinced that all is now well or even significantly better.

Look at what happened to the credit default swap (CDS) spreads on US banks yesterday. This is a small improvement, presumably because people feel somewhat comfortable that the Administration has no immediate intentions towards junior bank debt. And the drumbeat of positive spin from Messrs. Pandit, Lewis, and Buffett is having some effect - these are smart people, and they only put out such encouraging public words when their private information indicates that things are going much better.

Yet there is a tendency these days, even among leading global CEOs, toward tunnel vision. They see what is directly in front of them and do not want to focus on the storm clouds that are gathering a mile up the road. The roof has a massive hole, a hurricane has definitely been sighted, but it is sunny today. Should we talk about how sunny it is and how the hurricane might veer off, or should we undertake some rapid roof repairs? Should we focus on the level of CDS spreads or the latest tiny tightening?

The prevailing G7 official tendency in such situations is always: wait and see. Sometimes this is a great idea and works out just fine. Now seems unlikely to be such a time - it is far too easy to be overtaken, massively and disastrously, by events. Ask Hank Paulson about his experience in mid-September 2008.

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Mar 10, 2009 7:30 PM

Financial Crisis Macroeconomics for Beginners
If you want to get caught up on the financial and economic crisis in a hurry (and get a quick refresher on first-year macroeconomics), Charles Jones has drafted a new chapter on the crisis for his macroeconomics textbook. (If you’ve already read all of our Beginners posts, though, hopefully you won’t need to get caught up.) It’s 43 pages long (not very many words per page, though) and includes a relatively standard account of how the crisis came about (with a focus on the U.S. housing bubble), the impact on the real economy, and the thinking behind monetary policy, the fiscal stimulus, and the main proposals to fix the banking system. (Perhaps wisely, he doesn’t say which proposal - buying toxic assets, recapitalization, or reorganization - he recommends.) There is a discussion of what the crisis looks like in IS-LM terms - the main change from the standard version being the jump in the risk premium, which undermines the Fed’s ability to reduce effective interest rates. He also discusses the “zero bound” on nominal interest rates, in case you were wondering what that meant.

I think there should be a lot more on the crisis outside the U.S., for two reasons: first, it’s hitting harder in most other countries; and second, with so many countries being affected in so many different ways (Eastern Europe bubbles collapsing, China and Japan losing demand for exports, Russia hit by falling commodity prices, Iceland crashing under a hypertrophied banking sector), there would be lots to write about.

Jones even closes with a note of optimism:

Whatever happens in the coming years, it is worth remembering a key fact about the Great Depression, in evidence on the cover of the macroeconomics textbook . . . Even something as earth-shaking as the Great Depression essentially left the long-run GDP of the United States largely unaffected.

**Update:** I meant, but forgot, to add that Jones does not attempt to address the question of whether macroeconomics as a field needs to be revised in the light of the crisis. Mark Thoma has several posts on this question: a few are here, here, and here.

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**The World Bank And The Stress Test For U.S. Banks**
Forecasters at international organizations often find themselves in a delicate position. On the one hand, they have unparalleled access to hard data and intelligence about what is happening in every corner of the world economy. On the other hand, their main shareholders - the US and larger European countries - do not want to hear predictions that are inconsistent with their own preferred baseline.

And, in the case of the US today, nothing could be more sensitive: it’s a relatively optimistic baseline, with a quick bounceback next year, that underpins the mild “stress scenario” being used for banks. So if the World Bank or the IMF said that the world economy is going down and not coming back any time soon, that would raise major issues.

The World Bank clearly wants to speak truth to authority on this occasion, but can’t quite get the job done.

In a document prepared for the G20 meeting, the World Bank hints at more dire outcomes: global GDP will decline this year for the first time since WWII, with growth “at least 5 percentage points below potential” (translation: roughly minus 1 percent). But they don’t give any supporting country-level detail and they are completely silent on the key question for the US banking stress test - what will happen in 2010. They must have worked through this level of detail, otherwise they wouldn’t feel comfortable saying that the world economy will contract, and their body language (including the scale of funding requests for developing countries) says that this is going to stay bad for a while. But they can’t quite bring themselves to be explicit.

The document is a series of dire warnings, couched in rather indirect language - although, to an official ear, the general downbeat tone is quite clear. Then you reach section VII, “Urgent Priorities” and the recommendation for the financial system is: “restoring confidence”. This is completely vague and unhelpful - which, of course, is the point.

The President of the World Bank is, by tradition, appointed by the US government - specifically, in practice, by the Treasury. And there have long been voices - including from some now at the Treasury - suggesting that this should change, perhaps in return for more resources for the Bank/IMF from those emerging markets that still have deep pockets, e.g., China.

Still, what the odds that a more independent World Bank and IMF (the governance of which could be reformed in parallel) would ever play a decisive or even controversial oversight role vis-a-vis the US economy?

The US is just too powerful to be contained or constrained by international institutions. The idea of an global “early warning system” is therefore illusory.
We need to take this into account when redesigning our financial system. No one will warn us and we will not warn ourselves.

Nationalization for Beginners

from The Baseline Scenario by James Kwak

“Nationalization” has been the word of the last month, with support not only from the usual suspects, but from Lindsey Graham, Alan Greenspan, and (to some degree, although they won’t say the word) Richard Shelby and John McCain. However, different people ascribe different meanings to this word; in particular, opponents like to define nationalization as the government taking over every bank permanently and turning banking into a government service.

As I see it, there are at least five different meanings of nationalization.

1. Owning more than 50% of the bank, by which people typically mean owning more than 50% of the common equity

   This is a red herring, despite Treasury’s complicated efforts to keep its ownership stake in Citigroup below 50%. One entity can have effective control over another with less than 50% of its equity - through stock with special voting rights, or simply by being the largest shareholder. Conversely, one entity can own over 50% of another’s equity, yet not have any control, perhaps because it holds non-voting stock, or perhaps because it simply chooses not to exercise control.

2. Consolidating the bank onto the government balance sheet

   Above 80% ownership, things do get serious: at that point, the bank becomes part of the government balance sheet (unless there is some special treatment for the U.S. government that I’m not aware of). This means, among other things, that the bank’s debt becomes U.S. government debt, which increases the potential liability of the taxpayer. This is why, for example, all of Iceland’s banks defaulted on their debt just before being taken over by the state; otherwise Iceland’s citizens would have become responsible for their debts. This is also why it is unlikely to happen here.

3. Turning the bank into a government agency
In this scenario, banking becomes a government service, like getting a driver’s license or going to the unemployment office. Banking decisions - how much to pay depositors, who gets credit, on what terms, etc. - become the province of government bureaucrats. This would most likely be a bad idea, because these decisions - which, collectively, shape the flow of capital through the economy - are best entrusted to the free market. This is why no one is seriously considering this option here. However, when people argue against nationalization, this is often the straw man they are aiming at.

4. **FDIC-style conservatorship**

This is what the FDIC does when a bank it insures fails. FDIC bank supervisors determine that the bank’s assets are worth less than its liabilities. The bank itself is shut down and its assets are transferred to a new entity controlled by the FDIC. The FDIC attempts to maximize the value of these assets, typically by selling them to another bank or banks. From the customers’ standpoint, little changes during this period: the branches, ATM machines, web site, and so on remain in operation during the transition, except that customer may not be able to withdraw amounts above the insurance limits. If the proceeds do not cover the bank’s liabilities, the creditors lose out, but the FDIC makes sure that all the insured deposits are paid back. Note that going into conservatorship does not mean that the bank is consolidated onto the government balance sheet; the liabilities are not automatically guaranteed.

#4 is what most proponents of nationalization mean.

Those are four different versions of what it might mean to nationalize a bank. In addition, there is another type of nationalization that must be discussed and that, in fact, has largely occurred:

5. **System-level nationalization**

Banking in the United States, as in all advanced economies, has always been a public-private partnership rather than an unregulated free market. Banks play a critical role in the economy and therefore enjoy certain protections - such as FDIC insurance - and certain constraints - such as regulation. If the government had failed to act as the financial crisis unfolded, things would probably have gotten much worse, very quickly: not only Lehman Brothers but also Bear Stearns, Fannie Mae, Freddie Mac, AIG, Morgan Stanley, Citigroup, and probably Bank of America would have collapsed, causing trillions of dollars of losses for creditors and counterparties and bringing down other banks in sequence.

Instead, the government, primarily through the Federal Reserve, stepped into the breach. The government is the only source of capital for the banking system; it guarantees a large proportion of bank liabilities, including virtually all deposits and new bank debt; it implicitly guarantees all large banks under the Too Big To Fail doctrine; it ensures the liquidity that keeps the system afloat, both by providing cheap money and by lending against illiquid assets; and it has stepped up buying of various securities on secondary markets in order to encourage lending. In short, the government is where the money comes from, and the government decides on a high level where it goes, through capital injections, loans, and securities purchases. And the government bears the vast majority of the risk.
The net result is we have a semi-nationalized banking system largely made up of some very sick but private banks. As Thomas Hoenig put it:

We understandably would prefer not to “nationalize” these businesses, but in reacting as we are, we nevertheless are drifting into a situation where institutions are being nationalized piecemeal with no resolution of the crisis.

I am all in favor of debating to resolve the crisis. And I think that nationalization should be on the table, rather than being written off as some fundamental denial of the laws of physics.

Mar 9, 2009 7:42 AM

**President Obama’s Implied Future For Derivatives**

from The Baseline Scenario by Simon Johnson

If you’ve worked on economic policy formulation - or in any large bureaucracy - you know how to get your boss to make the decision you want. The key is to frame the options in such a way that he or she feels that your preferred course of action is the only plausible direction. Alternatives need to be undermined or discredited.

Smart bosses know this, of course, and they seek out sources of information or analysis that are not managed by their subordinates. The problem is that, traditionally, most such sources are not sufficiently well informed, at a detailed level, to be really helpful in the decision-making process. The format of most mainstream media - 800 words for the general reader, 4 minute stories, etc - does not allow engagement at the technical level; and, to be honest, technocrats are very good at manipulating the information flow to even the best journalist (who is usually a generalist). And while there are always outside technical domain experts, research papers appear with a lag and op eds usually have a broad brush (again, a format constraint).

Seen in this context, President Obama - on the face of it - has the role of blogs exactly backwards. But perhaps he is instead telling us something more profound.

In Sunday’s NYT, the President is quoted as saying (at the end of the story),

Part of the reason we don’t spend a lot of time looking at blogs is because if you haven’t looked at it very carefully, then you may be under the impression that somehow there’s a clean answer
one way or another - well, you just nationalize all the banks, or you just leave them alone and they’ll be fine.

Blogs relax previous format restrictions. Length can vary, as can technical content. Comments allow immediate feedback, clarification; debate is healthy for ideas. Experts can now express a view or an endorsement immediately to a broader audience - and get pushback, as appropriate.

And, on the President’s point, experts can now talk directly to other experts at a very detailed operational level, and the results of that conversation are now public - and again attract public content (let’s be honest: sometimes experts are way off-base and they need to be told). This is very threatening to official technocrats, both because their monopoly on expertise crumbles and because a broader set of people become skilled at criticizing their ideas. These technocrats would much rather have their boss read newspapers and weekly magazines.

There is a good reason that the IMF is not free to speak candidly about the United States; it is full of experts who know what they are talking about.

But the President knows all this, which suggests another interpretation for his remarks. Perhaps the financial situation - e.g., in and around derivatives - really is too complex for anyone to understand, unless they have the inside knowledge of regulators. This would mean, of course, that going forward no one can question Treasury about anything important.

But that, in turn, makes congressional oversight impossible - even if we move to closed door hearings. And it raises the question: if our financial system has become so economically complex that President Obama is right, then is it also too complex to be politically sustainable?

Big financial players now know they have a colossal potential put or bailout option. They can also construct interconnected structures that no one can understand, except possibly the Treasury. So every 10-20 years (or more often?) we will experience a crisis of current proportions?

There is a growing consensus that large banks should be broken up; no more “too big to fail”. But the President’s implied point about economic/political complexity suggests that derivatives - for all their obvious potential benefits - are too dangerous to be allowed at anything like their current scale. Who will be willing down the road to let Treasury, without outside comment or oversight, repeatedly provide massive amounts of resources to financial system insiders?

Derivatives have the potential to create a rent-seeking structure that is unparalleled in human history. No society can afford to allow that kind of financial system to operate. Either we figure out how to make it much more transparent - and amenable to outside review - or the re-regulation process currently in the hands of Senator Dodd and Congressman Frank needs to consider more radical alternatives.
Another day, another banking plan, this one from two senior partners at McKinsey and Company, which may be the most influential company you may never have heard of.

The authors recognize the toxic-asset pricing problem: If the government buys them at market value, the banks become insolvent instantly; if the government pays book value, it is paying a massive subsidy. They also recognize the rough scale of the problem, predicting another $1 trillion in writedowns. And here’s the proposal:

[W]e propose that the government step in and establish a voluntary program to create a real market price and terms for the sale of bad assets. Rather than use modeling for valuation, the program would set discounts from either of the two basic approaches to accounting value [fair value and "hold-to-maturity," which isn't quite accurate, but that doesn't matter], based on some recent past date (for instance, December 31, 2008). A reasonable level might be 10 percent off for securities already marked to fair value and 20 percent off for loans being held to maturity. Upon their sale to the government, existing shareholders would absorb the loss taken on the discount, and that loss of common stock value would be replaced by converting TARP preferred stock to nonvoting common (which would be vested with voting rights if sold to private parties).

I don’t see how this creates a “real market price.” If I’m a bank, I can sell to the government, at 10% or 20% off my book value, any assets I think are worth less than that; and I can keep all the ones I think are worth more than that. That’s not a market, it’s a free put option that rewards banks for having overstated the value of their assets. Even if you make the discount percentages bigger, it doesn’t change the basic dynamic: the banks will unload the worst assets, and keep the less bad ones. (Which might be one way to reduce uncertainty about the banks: “I’m really worried about all those toxic assets they are holding.” “Oh, don’t worry - they already dumped all the really bad ones on the taxpayer.”)

The authors argue that the subsidy is compensated for by the preferred-to-common conversion, which increases the government’s ownership stake. However, there’s a problem with this argument. Preferred stock is already worth something: when you convert it for common, you don’t magically get more value. Ordinarily, the value of the common you get should be the same as the value of the preferred you gave up. However, if you’re the government and you’re dealing with Citigroup, the common you get is worth a good deal less than the preferred you gave up. (At current prices, the government is exchanging $25 billion in preferred shares for about $8 billion in common shares. You could say that the preferred stock wasn’t actually worth $25 billion, but
that’s only the case because there was risk that Citi might not buy it back when it had to - and if Citi didn’t buy it back, then its common shares would be worth zero.)

But, the argument goes, if you bail out the banks in this way, the common will regain its lost value, and the taxpayer is better off eventually.

If restoring the ongoing-concern value of banks helped the industry’s valuation to regain its January 2007 level (about 20 percent less than its high), we calculate that the government’s shareholdings would be worth about $560 billion.

The S&P 500 Financial Sector Index spent January 2007 in the 490s. It hit its all-time high of 509 on February 20, 2007. Today, it’s 82. How long do you think it will be before it reaches 490 again?

If the government is going to buy toxic assets, I prefer Lucian Bebchuk’s model.

Separately, Alan Blinder, whom I usually agree with, has an op-ed outlining some of the potential problems with nationalization. Unlike many opponents of nationalization, Blinder has the decency to be clear what he is talking about:

Because “nationalization” can mean many things, let’s first clarify what the current debate is about. Don’t think Hugo Chávez or even Clement Attlee. Imagine instead that the government acquires a majority interest in — or perhaps 100 percent of — a bank, wipes out the existing shareholders and installs new managers. Then, sometime later, a healthy bank is sold back into private hands, and we all live happily ever after. At least that’s the idea.

However, after listing some reasonable concerns about nationalization, he settles on the good bank/bad bank proposal, without mentioning what Krugman points out: there’s no way to remove bad assets from good banks without someone - that is, the government - taking over the liabilities.

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Mar 8, 2009 6:41 AM

The FDIC Approach

from The Baseline Scenario by Simon Johnson
We have been arguing, here and elsewhere, for a banking approach centered around scaling up FDIC-interventions. Part of the pushback is (1) Congress won’t provide any more money, (2) there is no point in even going to ask, and (3) if you did go ask, that could be destabilizing.

In that context, I’m encouraged by the moves in and around the Senate at the end of last week to increase the resources available to the FDIC (for details, see my assessment on The New Republic’s site this morning). The Administration seems to be taking the lead and key senators are coming on board.

There are still a lot of pieces that can go wrong: the vaunted “stress test” looks weak, the signals on banks from the Fed and Treasury are mixed at best, and the banking lobby is digging in for a long struggle. And the world economy is going to put severe pressure on any approach.

But eventually we will turn a corner and, at that point, the FDIC will likely play a central role.

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**KC Fed President for Temporary Nationalization**

from The Baseline Scenario by James Kwak

Nemo alerted me (after in turn being alerted by Calculated Risk) to a recent paper by Thomas Hoenig, president of the Federal Reserve Bank of Kansas City, brilliantly entitled “Too Big Has Failed.” Here is an excerpt:

[T]he current path is beset by ad hoc decision making and the potential for much political interference, including efforts to force problem institutions to lend if they accept public funds; operate under other imposed controls; and limit management pay, bonuses and severance.

If an institution’s management has failed the test of the marketplace, these managers should be replaced. They should not be given public funds and then micro-managed, as we are now doing under TARP, with a set of political strings attached.

You could call this a free market argument in favor of temporary nationalization.

Here’s another:
For failed institutions that have proven to be too big or too complex to manage well, steps must be taken to break up their operations and sell them off in more manageable pieces. We must also look for other ways to limit the creation and growth of firms that might be considered “too big to fail.”

And my favorite:

Some are now claiming that public authorities do not have the expertise and capacity to take over and run a “too big to fail” institution. They contend that such takeovers would destroy a firm’s inherent value, give talented employees a reason to leave, cause further financial panic and require many years for the restructuring process. We should ask, though, why would anyone assume we are better off leaving an institution under the control of failing managers, dealing with the large volume of “toxic” assets they created and coping with a raft of politically imposed controls that would be placed on their operations?

This is coming from the head of a Federal Reserve member bank, not some blogger working on too little sleep. Calculated Risk speculates about the significance:

This strikes me as a break in the ranks, and although Hoenig is speaking for himself (not the Fed), this might indicate a change in direction.

The paper is only 15 pages and is very accessibly written.

From the Baseline Scenario by James Kwak

From the Washington Post:

[Scott] Polakoff [acting director of the Office of Thrift Supervision] acknowledged that his agency technically was charged with overseeing AIG and its troublesome Financial Products unit. AIG bought a savings and loan in 1999, and subsequently was able to select the OTS its primary regulator. But that left the small agency with the enormous job of overseeing a sprawling company that operated in 130 countries.

Is there another side to this story or is it really as simple as that?
Update: ProPublica had a good story on this back in November. Here’s one short excerpt:

Examiners mostly concurred with the company’s repeated assurances that any risk in the swaps portfolio was manageable. They went along in part because of AIG’s huge capital base . . . and because securities underlying the swaps had top credit ratings.

I want to pick up on a theme Simon discussed in his last two posts: the recent panic over bank debt, particularly subordinated bank debt. I’ll probably repeat some of what he said, but with a little more background.

Remember back to last September. What was the lesson of Lehman Brothers? The most important asset a bank has is confidence. If people are confident in a bank, it can continue to do business; if not, it can’t.

For the last six months, where has that confidence been coming from? Not from the banks’ balance sheets, certainly. And not, I would argue, from the dribs and drabs of capital and targeted asset guarantees provided by Treasury and the Fed. It has been coming from a widespread assumption that the U.S. government will not let the creditors of large banks lose money, out of fear of repeating the Lehman debacle.

The story goes something like this. Let’s say that Citigroup were restructured - via bankruptcy, or via government conservatorship - in such a way that creditors did not get all their money back. (None of this applies to FDIC-insured deposits or to recently-issued senior debt that is explicitly guaranteed by the government.) They might be forced to convert debt for equity, or they might be stiffed altogether. The first-order concern is that this would have ripple effects that could take down other financial institutions. According to Martin Wolf, bank bonds comprise one quarter of all U.S. investment-grade corporate bonds; losses would be spread far and wide, hitting other banks, pension funds, insurance companies, hedge funds, and so on. If Citigroup did not support its derivatives positions, then institutions that bought credit default swap protection from Citi would face further losses. (I believe that most U.S. banks were net buyers of CDS protection, however.) The fear is that it will be impossible to predict how these losses will be distributed and who else might go down.
The second-order concern is bigger. After all, Lehman did not seem to force any major financial institution into bankruptcy, although it may have twisted the knife that AIG had already stuck in itself. Once investors figure out that bank debt is not safe, they will refuse to lend to any banks, and we are back in September all over again. Or almost: it is possible that the Federal Reserve’s massive efforts to provide liquidity to the banking system will be enough to keep banks functioning. But who wants to take that risk?

This is why, for the last five months, the government has been doing everything it can to imply that bank creditors (at least for “systemically important” banks) will be protected, without saying so explicitly, because that would suddenly increase the potential liabilities of the government by trillions of dollars.

So what changed this week?

Simon’s theory is that the semi-forced conversion of Citigroup preferred into common shares was taken as a sign that the government may try to force creditors to exchange their bonds for common stock in future bailouts. Preferred shares are not, technically speaking, debt. But they
are a lot like debt, and once you finish converting preferred into common, the next layer of the capital structure is subordinated debt. Now, Tim Geithner could come out and say, “Yes, we forced a conversion of preferred into common, but we’re going to stop there and not do the same to creditors.” But no, actually, he can’t say that, because that would constitute an explicit guarantee of all bank liabilities. So the market is left wondering, and we know by now that markets don’t like uncertainty.

Another possibility is simply that more and more people are thinking that the government may end up restructuring debt. Martin Wolf and Willem Buiter, both very serious people, both have raised the question of whether the government should be protecting creditors. Wolf, I believe, doesn’t answer the question (although he discusses the issue very well); Buiter says no.

Each time the lines on that chart above have spiked upward, the government has taken some action to imply that creditors will be protected, without making any promises. Chances are we’ll see another action along those lines. At some point, though, the government may lose credibility.

As an aside, one of the steps in Sweden’s sometimes-heralded bank rescue program was an explicit government guarantee on all bank liabilities. If any country could guarantee its banks, you would think it would be the U.S. But the real barrier to taking such a step is probably political more than anything else.

Update (3/8): Krugman says:

[S]ome decision must be reached on bank liabilities. Sweden guaranteed all of them. If forced to say, I would go the Swedish route; but of course we can’t do that unless we’re prepared to put all troubled banks in receivership. And I’m ready to be persuaded that some debts should not be honored — this is a deeply technical question.
Thursday’s statement, to me, was about US banks (graph).

The risk of default for US banks, according to this market, is rising back towards levels not seen since mid-October. That is striking enough - but remember what has changed since then: (1) the G7 promised not to let any more systemic banks fail, (2) Treasury has provided repeated recapitalization funds on generous terms, and (3) the Fed offers massive, nontransparent funding to anyone in distress. How can it be that the credit market still or again feels the risk of default rising so sharply and to such high levels?

The most plausible interpretation - and here I’m willing to debate what the Oracle meant exactly - is that people expect the government will force the conversion of junior bank debt into equity. The treatment of private preferred shareholders at Citigroup, last week, is seen as the harbinger of further losses for investors.

In a comprehensive systemic clean-up approach and complete recapitalization approach, debt-equity swaps could potentially play a sensible role, particularly in countries without the fiscal capacity to sustain guarantees of all bank liabilities. But if they are done in chaotic crisis mode - as the government appears to be signalling - the additional damage to confidence around the world will be huge.

The events of mid-September 2008 were traumatic and awful to behold. I saw that trailer and I don’t want to see the movie. But it is exactly into that scary future that we now head.

It’s never too late to change policy, to make a difference, and to turn things around. But it is already very late.

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We Cannot Afford To Wait To Recapitalise US Banks (Letter To The FT)

from The Baseline Scenario by Simon Johnson

(The following is now available in the on-line edition of the Financial Times; link to original Martin Wolf article added here)

Sir, Martin Wolf’s excellent article on the pros and cons of nationalisation suggested, quoting Nouriel Roubini, that we could wait six months to determine how solvent US banks are before
making decisions ("To nationalise or not to nationalise is the question", March 4). This is possible but surely risky.

At Wednesday’s close, the junior subordinated debt of Citigroup (for example debt underlying the Citigroup XV 6.5 per cent Enhanced Trust Preferred Securities) yielded 27.6 per cent, and similar securities at many other large US banks yield high double digit amounts. With such yields on debt, anyone conducting business as a creditor with these banks must think twice. Why not withdraw the business to another safer bank, or just halt such business, until we understand the US government’s ultimate plan? If enough businesses and individuals take such actions, the core franchise of Citigroup and other similar large US banks could collapse. The government, six months from now, will be left with distressed bank franchises that are worth far less than they are today. At that point politicians and policymakers will probably determine it is only fair that creditors bear part of the cost, thus justifying the current high default risk priced into bank debt. This scenario, which is ever more likely as we wait, illustrates why authorities must take actions urgently.

A gradual disintegration of bank franchises will be met with more credit contraction and some new panics, thus deepening the recession and further reducing solvency of banks. The only credible solution is to embark immediately on a Federal Deposit Insurance Corporation-type intervention, recapitalisation, and early reprivatisation of US banks. The recapitalisation needs to be so large that it is near impossible to imagine an economic outcome where they fail in the next five years. That requires several trillion dollars, not the small sums left in the Trouble Asset Relief Programme and earmarked in the new US budget. Without these urgent measures, whether we nationalise or not, we are risking a highly undesirable outcome.

Peter Boone, Chairman, Effective Intervention; Centre for Economic Performance, London School of Economics, UK

Simon Johnson, Senior Fellow, Peterson Institute for International Economics; Professor, MIT Sloan School of Management, US

Confusion, Tunneling, And Looting

from The Baseline Scenario by Simon Johnson
Emerging market crises are marked by an increase in tunneling - i.e., borderline legal/illegal smuggling of value out of businesses. As time horizons become shorter, employees have less incentive to protect shareholder value and are more inclined to help out friends or prepare a soft exit for themselves.

Boris Fyodorov, the late Russian Minister of Finance who struggled for many years against corruption and the abuse of authority, could be blunt. Confusion helps the powerful, he argued. When there are complicated government bailout schemes, multiple exchange rates, or high inflation, it is very hard to keep track of market prices and to protect the value of firms. The result, if taken to an extreme, is looting: the collapse of banks, industrial firms, and other entities because the insiders take the money (or other valuables) and run.

This is the prospect now faced by the United States.

Treasury has made it clear that they will proceed with a “mix-and-match” strategy, as advertized. And people close to the Administration tell me things along the lines of”it will be messy” and “there is no alternative.” The people involved are convinced - and hold this almost as an unshakeable ideology - that this is the only way to bring private capital into banks.

This attempt to protect shareholders and insiders in large banks is misguided. Not only have these shareholders already been almost completely wiped out by the actions and inactions of the executives and boards in these banks (why haven’t these boards resigned?), but the government’s policy is creating toxic financial institutions that no one wants to touch either with equity investments or - increasingly - further credit.

Policy confusion is rampant. Did the government effectively sort-of nationalize Citigroup last Thursday when it said Vikram Pandit will stay on as CEO? If that wasn’t a nationalization moment (i.e., an assertion that the government is now the dominant shareholder), what legal authority does the Treasury have to decide who is and is not running a private company?

Will debtholders be forced to take losses and, if so, how much and for whom? As part of last week’s Citigroup deal, preferred shareholders - whose claims had debt-like characteristics - were pressed into converting to common stock. You may or may not like forced debt-for-equity swaps, but be aware of what the prospect of these will do to the credit market. Junior subordinated Citigroup debt (securities underlying enhanced trust preferred shares) were yesterday yielding 26%.

Who can explain exactly how AIG has lost so much money? Drip-drip injections of government money are not a proper clean-up; there has been no complete recognition of losses and, almost six months later, that company still cannot move on. Time horizons presumably remain short or are getting shorter for all involved. This points to a bleak future more generally.

What do rapidly widening credit default spreads for nonbank financial entities (such as GE Capital and many insurance companies) signify? Is it something about expected behavior by the insiders or by government, or by some combination of both?
Confusion in policy breeds disorder in companies, and disorder leads to the loss of value. This is the reality of severe crises wherever they unfold; we have not yet reached the worst moment. And, of course, there are many more shocks heading our way - mostly from Europe, but also potentially from Asia.

The course of policy is set. For at least the next 18 months, we know what to expect on the banking front. Now Treasury is committed, the leadership in this area will not deviate from a pro-insider policy for large banks; they are not interested in alternative approaches (I’ve asked). The result will be further destruction of the private credit system and more recourse to relatively nontransparent actions by the Federal Reserve, with all the risks that entails.

The road to economic hell is paved with good intentions and bad banks.
Or the year. Frightening.

I’ve been wondering why the impact of the financial crisis on the overall retirement “system” hasn’t gotten more attention in the media. We already knew the system was in bad shape before September 2008. According to the Fed’s Survey of Consumer Finances, in 2007, only 60.9% of households where the head of household was age 55-64 had retirement accounts . . . and their median retirement balance was $98,000. Given that the stock market has fallen by over 50% from its October 2007 peak - and that, for decades, the standard investment advice has been that stocks do better than any other asset class in the long term - we would be lucky if that median balance were more than $70,000 today.

The Bloomberg article linked to above describes the fragile state of state and local pension systems. These systems suffer from two major problems today. One is that even if they had been managed in a reasonable way, the fall in asset prices over the last year would have blown a huge hole in their long-term solvency.

The second, and the focus of the article, is the perverse behavior that is caused by accounting rules governing pension funds. The key question for a pension fund is whether the assets it has today will be enough to pay off its future liabilities. The assets are relatively easy to value, at least most of the time; the future liabilities are relatively easy to predict actuarially (although unanticipated developments, such as a sudden change in life expectancy, could mess up that calculation); but the hard part is estimating the rate of return on the assets. So . . . public pension funds are allowed to assess their long-term solvency using assumed annual rates of return, generally around 8% per year. Of course, as we know, things don’t always work out that way: the Vanguard Balanced Index Fund (which indexes virtually all U.S. stocks and bonds) has an average annual rate of return of 0.9% over the last 10 years, and even since its inception 1992 its annual return is only 6.0%.

These optimistic assumptions are bad enough, because they allow underfunding of pensions. But what’s even more bizarre is the behavior this causes. As the Bloomberg article explains, local governments issue pension obligation bonds to raise cash for their pension funds. These bonds usually pay fixed interest rates, say 6%, and the proceeds are then invested in risky assets. But the magical thing is that because you are allowed to assume an 8% return, for pension accounting purposes, the difference between 8% and 6% is free money! Well, it’s free money as far as this year’s assessment of the pension is concerned. In the long term, of course, it’s a crazy investment strategy (and a mistake many people make - comparing a risk-free interest rate you borrow money at with a risky expected rate you hope to earn). And the results in the future are predictable: either higher taxes, or yet more value-destroying pension obligation bonds. Sometimes people get caught saying stupid things, like Christine Whitman saying, “You’d be crazy not to have done this. It’s not a gimmick. This is an ongoing benefit to taxpayers,” but it’s really a systemic problem.

Our retirement “system” has four main legs: Medicare, Social Security, corporate or government defined-benefit pensions, and private saving (IRAs, 401(k)s, etc.). Right now it looks like Medicare and Social Security are the stronger legs.
Note: The Bloomberg article refers disapprovingly to Jon Corzine’s proposal to reduce state pension contributions during the recession. I actually agree with Corzine, at least on principle. When the pension fund’s assets fall because of a recession, you don’t want to force the state to make up the difference immediately, because that would be extremely procyclical - it would cripple the state budget right when you want to be spending more, not less. The converse, of course, is that when the economy is good and tax revenues are high you should over-contribute to the pension fund - not just make up for the recession years, but also build up a surplus. We’ll see if that happens.

Did Goldman Sachs Just Win Big?

from The Baseline Scenario by Simon Johnson

On p.A4 of today’s WSJ, Deborah Solomon and Jon Hilsenrath report more detail on the Treasury’s “Bad Bank” funding plan. On first (and third) read I’m not impressed, but we’ll go through all the available details and report back later.

For now, I just have one question. Isn’t this essentially the same plan that Goldman Sachs has been shopping around for the past month or so? There’s nothing necessarily wrong with that, of course. But it would be a huge win for Goldman and Lloyd Blankfein - explaining, for example, the confidence displayed in his recent FT article.

And, whatever the reality of lobbying, pressure, and idea exchange here, the optics (as they say in the message spinning business) don’t look great.


from The Baseline Scenario by Simon Johnson
In an extraordinary interview just now on NPR’s morning edition (at the top of the hour; to be rebroadcast in 2 hours, just after 9am Eastern; audio recording should be available at around that time also), Steve Inskeep pushed Gordon Brown hard.

My favorite part is when Steve asked the Prime Minister whether, during his stewardship of the British economy over the past 10 years, he had worried about “too much debt” being taken on by consumers and firms and excessively risky lending. Brown’s response, “our corporates did not borrow too much.” Not answering on the other dimensions of the runaway lending boom says it all - Britain had an unassisted, unsustainable property and financial sector bubble.

But apparently no one now bears responsibility for this, because then Brown falls back on what appears to be the current line for him and other US/global leaders, “it’s a global crisis” - with blame (of course!) placed on “massive capital flows” after the Asian financial crisis of 1997-98. In a masterful piece of political misdirection, Brown mixes platitudes (betters rules and standards), obvious ideas (governments ready to take regulatory actions against shadow banks), and things that he has implacably and effectively opposed in the past (a more effective global early warning system).

There is no acknowledgment of massive regulatory breakdowns in Britain or his inactions on all relevant fronts while he was the long-standing chair of the ministerial body that oversees the IMF’s activities.

Steve Inskeep asks point blank if we can have a return to strong growth in 2010, as assumed in the Obama Administration’s budget and banking stress tests. Brown ducks - we’ve done a lot, he says. Of course, they haven’t really, but the joint official line coordinated across countries seems to be, “repeat this often, and perhaps people will start to believe it.”

There is one silver lining, potentially. Prime Minister Brown stresses, early on, that this is a “banking crisis” and we need to “clean up the banks.” Hopefully, he will convey this message forcefully to President Obama later today.

**Update:** in early coverage, Reuters spots the duck on growth (but not on stewardship):

He did not directly answer a question about whether there would be strong economic growth next year but said the stimulus packages, combined with cooperation among governments, would “make a big difference to our chances of recovery quickly.”
What Should President Obama And Prime Minister Brown Discuss?

from The Baseline Scenario by Simon Johnson

I’d like to imagine that President Obama and Prime Minister Brown will this week discuss how the global economy is worsening, and why all official forecasts need to be revised down substantially, again - with immediate implications for stress tests in the US and realistic bank recapitalization in the UK.

But this is a stretch. On the US side, too much public effort over the past week has gone into repainting a rosy baseline - e.g., in Chairman Bernanke’s testimony last Tuesday and the budget documents unveiled on Thursday. No leader can back away so quickly - even in private - from this kind of thinking, no matter how much they now begin to worry about the latest haphazard rounds with Citi/AIG or the worsening of financial markets around the world. Both Obama and Brown are unfortunately stuck, for the time being, with Wait And See approaches.

So, over on Forbes.com, Peter Boone and I suggest some more plausible topics for their conversation. Naturally, I would start with the eurozone…

AIG in Review

from The Baseline Scenario by James Kwak

Well, it’s done. AIG is getting another bailout.

I have to admit I don’t fully understand the ongoing AIG bailout saga, so I thought I would do a little research to try to figure out what is going on. I thought I would just look up all the term sheets, but I found it’s harder to get that kind of information from the Federal Reserve web site
than from the Treasury web site. For example, the original September 16 press release doesn’t say what the terms of the 79.9% equity interest are, and I still haven’t been able to figure that out. If you know the details, let me know and I’ll update this post. In any case, I think this is the best single-page overview you’ll find on the web.

September 16: The Federal Reserve gave AIG an $85 billion line of credit for 2 years at a very high interest rate - 3-month LIBOR (an interbank lending rate, which is generally pretty low) plus 8.5 percentage points on the full amount (whether or not it was drawn down). In exchange, the government (not sure which entity) got warrants on 79.9% of AIG stock - I don’t know what the price was, or if they were ever exercised.

October 8: By early October, AIG had already drawn down over $60 billion of its credit line. The Federal Reserve authorized the New York Fed to “borrow” up to $37.8 billion in illiquid securities from AIG and give it “cash collateral” (I think that means “cash”) in return. The problem was that AIG had lent some securities (call them A) to counterparties in exchange for cash or other collateral (call that B), and had then used B to buy some other securities (C) that had lost value. So when the counterparty wanted to return A and get B back, AIG couldn’t give them B back, because the money was tied up in C. So the New York Fed agreed to take C and give AIG cash so AIG could close out its trade - meaning the Fed effectively got stuck with the risk.

November 10: This time the Fed and Treasury got together.

- Treasury invested $40 billion of TARP money in AIG for preferred stock paying a 10% dividend. Treasury also got warrants with an exercise price of $2.50 on 2% of AIG’s outstanding common stock (although I don’t know how this relates to the original warrants on 79.9% of the common stock.)

- Some of that $40 billion was used to pay back the line of credit, which was reduced from $85 billion to $60 billion. The interest rate was reduced from LIBOR + 8.5 percentage points to LIBOR + 3 percentage points (a huge reduction), and the term was extended from 2 years to 5 years.

- The New York Fed created a new entity called AIG RMBS LLC with $1 billion from AIG and a $19.8 billion loan from the Fed. That $20.8 billion was used to buy residential mortgage-backed securities from AIG. Those securities had a face value of $40 billion but a “fair value” of $20.8 billion, or 52 cents on the dollar. (I wonder what those RMBS were on the books at prior to the sale.) The purpose here was simply to relieve AIG of some toxic assets and minimize its losses on them. Interest on those securities and proceeds from sale will pay back the loan to the Fed, meaning that AIG will take the first $1 billion in losses and the Fed anything else. The $20.8 billion paid to AIG (to buy the securities) was paid back to the New York Fed to retire the lending/borrowing facility created on October 8.

- The New York Fed created another entity called AIG CDO LLC with $5 billion from AIG and a loan of up to $30 billion from the Fed. The purpose of this entity was to buy
CDOs from third parties who had purchased “insurance” (credit default swaps) from
AIG. Since AIG’s biggest exposure was the possibility of having to pay out on this
insurance, the idea was to buy up the assets (CDOs, in this case) that had been insured
and require the third party to close the CDS contract. (Imagine AIG had underpriced
insurance for houses on the Gulf Coast, and the government was buying the houses in
order to cancel the insurance contracts.) According to the Fed web site, it looks like this
entity has spent $20.1 billion to buy up CDOs with an aggregate face value of $53.5
billion - 38 cents on the dollar - but I’m not certain I’m reading that correctly. If those
CDOs lose value, AIG bears the first $5 billion in losses, and the Fed bears the rest.

So as of November AIG had a $40 billion preferred stock injection and a $60 billion credit line.
AIG had also put $6 billion into two new entities which could borrow up to $50 billion from the
Fed and use the total funds to buy toxic assets: some from AIG (and I have no idea if we
overpaid for those or not) and some from third parties.

March 2 (updated 3/2 7:30 am): The announcements are out.

- The $40 billion in preferred shares that Treasury got in November are being exchanged
  for $40 billion in preferred shares that are on better terms for AIG. There’s no way to get
  around this point. It’s the Series D to Series E conversion on the term sheet. The new
  preferred shares pay a “non-cumulative” dividend, which means they basically pay no
  dividend. More specifically, they only pay a dividend if AIG decides to pay the dividend.
  And they are non-cumulative, meaning that if AIG skips a dividend payment, they never
  have to pay it. (With a cumulative dividend, if you skip one payment, it gets added onto
  the next one.) The only condition is that if AIG skips the dividend for eight quarters in a
  row, Treasury can appoint some members of the board of directors.

- In addition, Treasury is providing up to $30 billion more in cash in exchange for more
  preferred shares on yet different terms. That’s the Series F on the term sheet. I don’t see
  anything about dividends, so this is basically an interest-free five-year loan.

- The terms on the credit line will be improved by reducing the floor on the interest rate
  (previously 6.5%). In addition, the credit line will be reduced by up to $34.5 billion,
  according to the two following provisions.

- Two life insurance subsidiaries will be put into separate trusts. After AIG and the New
  York Fed agree on the valuations of those subsidiaries, the Fed will buy up to $26 billion
  in preferred stock in these trusts. That money will be used to pay down the credit line.

- AIG will create new entities that own the rights to the cash flows from certain blocks of
  life insurance policies. The New York Fed will loan these entities $8.5 billion, which
  AIG will turn around and use to pay down the credit line. The $8.5 billion will be paid
  back (or not) by the new entities from the life insurance cash flows. (In other words, AIG
  is securitizing the life insurance policies and the Fed is buying the securities for $8.5
  billion.)
AIG is issuing convertible preferred stock equivalent to a 77.9% ownership share to Treasury. This looks like Treasury is exercising the rights it got under the original loan agreement. The terms of the convertible preferred stock were not released as far as I can tell, but we can probably assume there are no dividends.

In summary: AIG gets better terms on the first $40 billion in preferred stock; AIG gets $30 billion more in cash in exchange for new preferred stock on even better terms; and the credit line gets reduced by giving Treasury some assets (that AIG was presumably unable to sell on the open market). The overall effect is to reduce AIG’s debt burden and shift more risk to the taxpayer. Whether the taxpayer got a good price for taking on that risk is far too complicated for anyone to figure out from just reading a term sheet, since it depends on the nature of the assets.

I know that AIG is different in many respects from the banks that everyone is worried about. In particular, AIG was a net seller of CDS protection, while most banks are (should have been?) net buyers of protection. But one thing still scares me. When the weekend of September 13-14 began, AIG said it needed $40 billion. After digging through the books, Goldman and JPMorgan put the price tag at $75 billion, and declined to put together a consortium to lend the money. The Fed lent $85 billion, thinking that would be enough. Almost six months later, we still don’t know the extent of the damage.

**Update:** I rewrote the March 2 section.

**Update 2:** Does anyone else find it strange that, less than one week after announcing that future capital will be given to banks in the form of convertible preferred shares with a 10% dividend, Treasury has already issued preferred stock on three different sets of terms (one to Citigroup and two to AIG), none of which are consistent with last week’s announcement? Also, with the AIG Series E and F, we have reached a new high (or low) of generosity, with a noncumulative dividend in one case and no dividend in the other. Of course, this is a company we already “own” - we control most of the equity, and we have implicitly guaranteed the debt - so maybe none of these terms really matter.
I finally got around to listening to Tim Geithner’s interview with Adam Davidson for Planet Money. (Simon already commented on it.) I had two main reactions.

1. Around the 14:30 mark, in response to a question about the problem of valuing bank assets, Geithner said this:

If somebody asks you, “what’s your home worth today?,” your answer to that question would be dependent on whether you had to sell it today, or you were planning to sell it in three years . . . or you were planning to sell it in ten years . . . So that basic challenge of trying to figure out what your home is worth, or what any asset is worth, depends a lot on how long are you’re going to hold it, and it depends a lot on whether there’s going to be financing available to people out there who might buy it. And in the absence of financing, if you had to sell it today, it would be worth a fraction of its basic value. Now, what’s happening in our market today is that we have just a broad shortage of financing available. And what the government needs to do in that context . . . is to try to make sure that the government and the central bank together can provide the financing to help get those markets working. And that will make it more likely that these assets are worth and will have the value that is their basic inherent economic value rather than an artificially depressed value that reflects the absence of financing and credit.

Yes, someday the economy will start to recover. And yes, someday it will be easier to get a mortgage (although it should be noted that mortgage rates are historically low right now, so mortgage rates will probably be higher in the future). When the economy starts to recover, housing prices will start going up. But we have no idea where the bottom will be, and so there is no assurance that even in ten years you will be able to sell your house for more than you paid for it. There isn’t even any assurance that you will be able to sell your house for more than it is worth now. If, as some people believe, housing prices still have another 20% to fall, it could take ten years to make that up. And there are some people who argue that, in the absence of increasing population density, there is no reason for real housing prices to go up at all.

The idea that houses have a “basic inherent economic value” other than the prices they can fetch in the housing market is, I think, a fallacy. And so the idea that therefore houses will naturally return to some “basic inherent economic value” that is higher than current market prices is, I think, wishful thinking of the kind that has hampered responses to this crisis from the beginning. They could; but they could just as well not.

2. Near the end, when Adam Davidson was trying to get Geithner to say something, anything, about nationalization, he said this:

It’s not the right strategy for our country for basic practical reasons that our system will be stronger if it remains in private hands with support from the government to make sure those institutions can play their critical role going forward.

I listened to the end but I didn’t hear any “basic practical reasons.” To be blunt, it sounded like the “private is better” mantra we heard from the Bush administration, and (to a slightly less extent) the Clinton administration before them. Sure, most people agree you don’t want all individual lending decisions being made by bureaucrats in Washington, but that’s just a straw
man. There are valid reasons to debate whether nationalization is the best solution; in particular, if you were to take over Citigroup, even for a short period of time, would that immediately weaken Bank of America so much that you would be forced to take it over the next day? And what about JPMorgan Chase? But that’s not what Geithner said. He said “private is better.”

Now, maybe that’s just because Tim Geithner doesn’t want to get into a serious debate about the merits of government takeovers on national radio, because he’s afraid of the impact that might have on the markets. I respect that. But let’s hope that when they have these debates in private, they don’t just write “private is better” on the whiteboard and call it a meeting.