The Baseline Scenario 2009-07
July 2009

This Is Their Reform Strategy For Big Banks?

Simon Johnson  | 02 Jul 2009

Anil Kashyap is one of our leading researchers on banks. His book with Takeo Hoshi on the evolution of the Japanese corporate finance is a must read on the twists and turns that built a great economy and then laid it low. And he has many other papers and relevant recent commentary.

Professor Kashyap has a sharp perspective the administration’s financial sector reform thinking, in part because he has long worked alongside key people now at the National Economic Council (the NEC, by the way, has disappointingly little transparency; even Treasury is more open).

So we should take him seriously, writing Tuesday in the Financial Times, on the importance of the proposed new “funeral plans” for banks.

Kashyap’s point is that if banks are forced to explain, in convincing detail, how they can be wound down, this will effectively limit the complexity and scale of their operations. (See “Rapid Resolution Plans” on p.25 of the regulatory reform proposals; p.26 in the online NYT version)

The notion is intriguing, if such rules are actually enforced. Essentially, banks would be required to specify the extent and nature of costs for any bailout they may require.

A key part of any plan would be the people involved. Are there critical individuals who would need to be kept on to wind down positions (as was claimed to be the case with AIG FP)? Would they therefore require large retention bonuses? How large exactly?

You can see how such resolution planning might go wrong – particularly if banks were only forced to consider whatever they now regard as “normal” risks. Remember the head of quantitative equity strategies who said, in early August 2007, “Events that models only predicted would happen once in 10,000 years happened every day for three days.”
A checklist approach is definitely not going to work (been there, done that, for countries). You need something that can simulated or, even better, played out in a war game. Bring in some difficult outsiders and try to break the bank in the messiest way possible (in a game), then follow the consequences and costs.

These banks are so large and intertwined with so many other, it’s hard to fathom how a “funeral plan” would be reassuring – unless it means that they become smaller and less complex.

And this brings up the real weakness of this approach to reform – the political economy. How do regulators of any kind press for meaningful plans regarding closing down, say, Citigroup or JP Morgan Chase? The CEOs of those firms have direct access to the Secretary of the Treasury and on Pennsylvania avenue they are regarded as gurus and bastions of the economy. They’ll say, “look, if you let this person force us to simplify our business, there will be less credit growth and a big recession.” Which recent Treasury Secretary would be able, at that moment, to face them down – particularly as these bankers can, if pushed, go to the big boss?

On top of this, keep in mind there is no cross-border resolution authority currently on the table in the US regulatory reform proposals or at the G20 level. The Europeans say they are inching in this direction; I’ll believe that when I see it. In our next boom-bust iteration, big banks may well be regarded as having “too many cross-border liabilities to fail”, so there’ll be another quasi-bailout with potentially huge fiscal costs.

And then someone will promise a new regulatory reform plan.

_By Simon Johnson_
How To Buy Friends And Alienate People

Simon Johnson  | 03 Jul 2009

The banking industry is exceeding all expectations. The biggest players are raking in profits and planning much higher compensation so far this year, on the back of increased market share (wouldn’t you like two of your major competitors to go out of business?). And banks in general are managing to project widely a completely negative attitude towards all attempts to protect consumers.

This is a dangerous combination for the industry, yet it is not being handled well. Just look at the current strategy of the American Bankers’ Association.

Edward L. Yingling is justifiably proud of his organization’s postion as one of the country’s most powerful lobbies.

His testimony to Congress on the potential new Consumer Financial Protection Agency plainly shows where his group stands. The most revealing quote, highlighted in the ABA’s own press release, reads:

“It is now widely understood that the current economic situation originated primarily in the largely unregulated non-bank sector,” he said. “Banks watched as mortgage brokers and others made loans to consumers that a good banker just would not make and they now face the prospect of another burdensome layer of regulation aimed primarily at their less-regulated or unregulated competitors. It is simply unfair to inflict another burden on these banks that had nothing to do with the problems that were created.”

The premise here is false. If major banks had really not been involved in the mortgage fiasco, we would not have had to roughly double our national debt-to-GDP in order to save the US and world economy.

Within the banking community, and presumably within the ABA’s membership, there is serious tension. The small banks feel – overall with some justification – that the essence of the recent problem was not about them. But they can’t bring themselves to suggest publicly that the economic and political power of the largest banks should be curtailed.

Small banks have always had clout in the American political system, particularly when they work through the Senate. But we have not always had our current kind of crisis. The executives of these banks lived comfortably in the 1950s and 1960s; their kind of banking was boring, stable, and nicely remunerated.
It is the changing nature and power of the largest financial institutions – banks of various kinds – that has damaged our system since the 1980s; the rise in financial services compensation is part symptom and part pathogen. Big banks present the major risk going forward – to both the economy in general and to smaller banks in particular.

Most banks are “small enough to fail” (seven closed yesterday). It is absolutely not in their interest to have some banks that are perceived to be “too big to fail” and to ever re-run any version of the last two years.

The ABA should be discussing and addressing this issue. Instead, it is making all banks unpopular by opposing sensible legislation aimed at protecting consumers – look at the public relations context provided, for example, by Citi’s recent move on credit cards.

The ABA’s leadership needs to quickly rethink its approach.

By Simon Johnson
Catching Up with the Bandwagon

James Kwak  | 05 Jul 2009

Sorry about the recent silence; I’ve been trying to kill off a rewrite of a paper, and sometimes I find that to get things done you just have to be singleminded about your priorities.

In case you haven’t seen them yet, I wanted to point out a couple of things that have been making the rounds of the Internet:

- Most of the people writing about health care reform on economics blogs – present company included – are not health care economics specialists. Uwe Reinhardt is. So when he writes about “rationing health care,” I recommend reading (hat tip Mark Thoma).
- Brad Setser is branching out from foreign reserves, holdings of U.S. government and agency bonds, and China – on which he is probably the leading figure on the Internet – to, well, everything. Visit the Council on Foreign Relations’ “Crisis Guide: The Global Economy” and click on Motion Charts. There are four charts in the sidebar to the right. For each one, you can watch Setser on video, or you can click the “Interact with Motion Chart” link and play with it yourself.

Happy reading.

By James Kwak
The Jones Doctrine: Economic Development For Afghanistan

Simon Johnson | 05 Jul 2009

The administration is signaling a new strategy for Afghanistan: “economic development and governance”. On the front page of the Washington Post last week, President Obama’s national security adviser, James L. Jones, told Bob Woodward:

“The piece of the strategy that has to work in the next year is economic development. If that is not done right, there are not enough troops in the world to succeed.”

This is an appealing statement. But does it make any sense?

Providing people with the means to earn a decent standard of living is a good thing in itself, and better future prospects can encourage them not to fight. Economic stress often – but not always – encourages violence.

Still, there are three problems with the Jones Doctrine, as applied to modern Afghanistan.

1. Economic development generally requires a high level of physical security. You only make investments if you are reasonably confident that you will live to see the benefits of those investments. If setting up a store or planting more acreage raises your profile in the community and makes you more of a target, why not keep your head down? The Taliban knows this and acts accordingly. Economic development is something that follows – hopefully - from more physical security, rather than providing an alternative.

2. The U.S. can provide more resources to targeted communities, e.g., roads and other physical infrastructure, improved health, and more teachers. But none of this necessarily adds up to sustained increases in incomes. This may not be a problem, if we are willing to keep ploughing money in essentially without limit. But what is the budget for this activity and how much support does it have on Capitol Hill?

3. If you can achieve security and provide infrastructure, what exactly will the rural citizens of Afghanistan invest in? If it’s opium poppy production, doesn’t that create a whole other set of issues? If you try to prevent people from cultivating poppy, what exactly are their alternatives – and how much money can they make? If you try to eradicate poppy production, doesn’t that
undermine the physical security goal? And if the poppy trade gains the upper hand, doesn’t that support illegality and mafia-type activity in both Afghanistan and its neighbors? How does that impact the Jones’ Doctrine sensible emphasis on improving governance?

All of these questions surely have answers, but none of these answers seem easy or should be assumed to have political support. If you really want to switch emphasis in Afghanistan, there needs to be a much more engaged and detailed conversation – led by the White House and very much involving Congress.

As it currently stands, the Jones Doctrine appears more as a slogan for an intra-military discussion about troop levels (68,000 vs. 100,000). Or perhaps it is just an exhortation to keep civilian casualties down – a sensible goal, but not by itself offering a way out of the quagmire.

By Simon Johnson
The Importance of Mark Thoma

James Kwak  | 06 Jul 2009

David Warsh has an article about economics blogging that is focused on Mark Thoma. Mark isn’t the most controversial blogger on the Internet, but he is one of the most invaluable, because he provides long excerpts of lots of economics material, from all different perspectives. (He also has his own points of view, but he is willing to entertain people who don’t agree with him. He is also gracious and welcoming to new bloggers (like we were not so long ago). If you have a general interest in economics and don’t subscribe to him, check him out.

By James Kwak
Paul Krugman is generally credited with coining the term “fifty little Hoovers” to refer to our state governments and the current economic crisis. The macroeconomics textbook says that when a recession hits, the government should implement expansionary policy, whether monetary – making cheap money available – or fiscal – borrowing money and spending it to compensate for falling private-sector demand. However, states have no monetary policy, since they don’t control the money supply, and they generally can’t engage in expansionary fiscal policy, because most have made it prohibitively difficult to borrow money and go into deficit. So in a recession, states tend to cut spending and raise taxes, which only compound the effect of a recession. Since most states’ fiscal years end on June 30, some of the effects of this belt-tightening should be hitting right about now.

One thing that states spend money on, but that people generally don’t think about, is legal services for poor people. I think about this because I am spending the summer working (for free) for a legal services provider in Massachusetts. In Massachusetts, like in many states, funding for legal services for the poor comes mainly from two sources: (a) interest on lawyers’ trust accounts (IOLTA) – that is, the short-term interest paid on money that your lawyer is holding for you for some reason; and (b) direct appropriations in the state budget.

Well, you can see where this is going. The Times had an article earlier this year about the impact of the financial crisis and the collapse in short-term interest rates on IOLTA money, talking about staffing cuts of 20% or more. Since then, things have only gotten worse. In Massachusetts, projected IOLTA funding has falling from $26 million to $10 million, and the direct appropriation was cut from $11 million to $9.5 million (it could have been as low as $8 million); put those numbers together, and you get a 47% cut in funding from our two main sources. (Those aren’t the only sources of funding, so the total impact may be less – or it may be more. I don’t really know much about the administrative side of things.)

We’ve adapted mainly through voluntary attrition and severe cuts in hours for most of the staff, but the real losers all over the country will be people who are turned away at the doors of legal services offices. Legal rights, it turns out, are a little like health care; they can be really important – if, for example, your landlord is trying to evict you, or if
some government agency made a mistake in calculating your benefits – but you generally need money to defend them. And in this case, if the state doesn’t provide services to people who can’t afford lawyers, no one will. I’d like to see what the free-market solution is here: maybe someone will suggest having lightly-regulated competition between legal insurance providers.

As an aside, most of my legal services organization is probably now “part-time for economic reasons,” a category that now makes up more than 5% of the work force. That may or may not constitute a drag on the unemployment rate when the economy finally turns around; Calculated Risk thinks not.

*By James Kwak*
The Mystery of Rating Agencies

James Kwak | 06 Jul 2009

Calculated Risk has a routine post about S&P increasing its loss projections for subprime and Alt-A loans and for the mortgage-backed securities built out of those loans. These announcements have been so common over the last several months that I usually don’t even think about them. But today I had a thought about them: these are forecasts, which means that they should not get worse just because the economy is getting worse. Forecasts should only change when there is new news that affects expectations about the future. So if you take these rating agency reports at face value, they imply not only that the economy is getting worse (by traditional measures such as the unemployment rate), but that there is new bad news about the future of the economy, despite all this talk you hear about green shoots and a recovery. If there is only old news, then that should have been “priced in” to S&P’s forecasts already.

So what gives? Do the rating agencies see some new perils in the economy that are being overlooked? Or are they just stretching out a writedown in their forecasts over several quarters? Under the latter theory, they should have known what would happen to subprime and Alt-A loans the same time people like Calculated Risk did – that is, several months ago – but it would be too embarrassing to do a massive writedown all at once, so they are spreading it out over time for respectability.

By James Kwak
The Efficient Market for Cristiano Ronaldo

James Kwak | 07 Jul 2009

Cristiano Ronaldo, perhaps the best soccer player in the world and still only 24 years old, was sold by Manchester United to Real Madrid for 94 million euros (that’s just the transfer fee, and has nothing to do with his salary). Ronaldo:

“I think it’s a fair price. If Manchester and Real agreed on the price, there is nothing to add.”

Eugene Fama could not have put it any better. Perhaps Ronaldo has an investment banking career in his future.

**Update:** tkt points out in the comments that Zinedine Zidane was actually more expensive in real terms. If I recall correctly his transfer fee was over 70 million euros in 2001, so that’s almost certainly right.

*By James Kwak*
The Fed Makes A Bid

Simon Johnson  | 07 Jul 2009

Policymakers like to make particular kinds of statements at a “low attention” moment, e.g., right before a holiday weekend. This gets items onto the public record but ensures they do not get too much attention. And if you are asked about these substantive issues down the road, you can always say, “we told you this already, so it’s not now news” – usually this keeps things off the front page.

Released on July 3rd (a federal holiday), and buried inside the Washington Post on Saturday (p.A12): An important speech (from June 26th) by the New York Fed’s controversial President, William C. Dudley.

If the Fed is to become the system or any kind of “macroprudential” regulator, what would it do with that responsibility? This is a hot topic for Capitol Hill in coming weeks as various committees take on this topic in whole or part.

Dudley says that the Fed can pop or prevent asset bubbles from developing. This would represent a major change in the nature of American (and G7) central banking. It’s a huge statement – throwing the Greenspan years out of the door, without ceremony.

It’s also an attractive idea. But how will the Fed actually implement? Senior Fed officials in 2007 and 2008 were quite clear that there is no technology that would allow them to “sniff” bubbles accurately – and this was in the face of a housing bubble that, in retrospect, Dudley says was obvious.

Dudley is quiet on whether or not, for example, we have an emergent bubble in emerging markets today. Is there also an effective bubble in US Treasuries, as John Campbell has argued persuasively?

“Asset bubbles may not be that hard to identify,” Dudley argues. Fine, but it would help to know exactly the Fed would do this ex ante – not using the rear view mirror.

Of course, if the Fed can’t get better at spotting bubbles, the implication is that no one can. Which means that “macroprudential regulator” is just a slogan – a nice piece of what Lenin liked to call “agitprop”.

And if macroprudentially regulating is an illusion, what does that imply? There will be bubbles and there will be busts. Next time, however, will there be financial institutions (banks, insurance
companies, asset managers, you name it) who are – or are perceived to be – “too big to fail”?

You cannot stop the tide and you cannot prevent financial crises. But you can limit the cost of those crises if your biggest players are small enough to fail.

*By Simon Johnson*
Still Skeptical About Banks

James Kwak | 07 Jul 2009

It’s getting somewhat lonelier being a large financial institution skeptic, although there still a lot of us left. I would say that among the skeptics, the general view is that we may have seen an end to bank panics for this cycle – I’m not sure anyone is saying there will definitely be another crisis in the near future – but we may not have, and we may come to regret not taking stronger measures now. (How’s that for prognostication?)

Lucian Bebchuk, in Project Syndicate (a well-intentioned collaboration that manages to sound ominous and conspiratorial), makes the argument in clear terms. First, the recent stress tests only projected losses through 2010, ignoring the large number of loans and mortgage- and asset-backed securities that mature in later years. More fundamentally, though: “Rather than estimate the economic value of banks’ assets – what the assets would fetch in a well-functioning market – and the extent to which they exceed liabilities, the stress tests merely sought to verify that the banks’ accounting losses over the next two years will not exhaust their capital as recorded in their books.” Put another way, the focus has been on the accounting value of assets, not their economic value; so for a given asset, as long as it doesn’t have to be written down before the end of 2010, there is no problem.

Bebchuk also points out that the ability of banks to raise equity capital should not be taken as an “all clear” sign. As he and others have previously argued, equity in large banks by its very nature represents a leveraged bet whose downside risk is limited by the implicit government guarantee. That is, as a shareholder, if the economy does OK and bank assets appreciate in value, you get all of the upside (leveraged by the bank’s liabilities); if the economy does terribly and bank assets fall in value, your losses are not only limited to the amount of your investment, they are further limited by the implicit guarantee that the government will not wipe you out. That guarantee is weaker than the implicit guarantee on bank liabilities, but it is still there; given the way the government has treated Citigroup, Bank of America, and GMAC, betting on the “no more Lehmans” policy seems like a sensible bet.

Most attention is now focused on the battle over financial regulation (if it isn’t on health care and energy), which is appropriate. But it may be premature to declare victory over the financial crisis.
By James Kwak
Recently Bailed-Out Banks Refuse to Take California IOUs

James Kwak  | 08 Jul 2009

The Wall Street Journal (via Calculated Risk) reports that a group of large banks has announced that it will not accept IOUs issued by the state of California. The group includes the four horsemen of the financial crisis: Citigroup, Bank of America/Merrill/Countrywide, JPMorgan Chase/Bear Stearns/WaMu, and Wells Fargo/Wachovia.

Write your own ironic commentary.

By James Kwak

Simon Johnson  | 08 Jul 2009

The G7 was originally conceived as a form of steering committee for the world economy (antecedents). Existing formal governance mechanisms, around the IMF and the UN, seemed too cumbersome (and too inclusive) during the 1970s, with the breakdown of fixed exchange rates, assorted oil shocks, and the broader shift of economic initiative towards Western Europe and Japan.

And the G7 had some significant moments, particularly with regard to moving exchange rates in the 1980s. More broadly, behind the scenes, it served as a communication mechanism between the world’s largest economies (“coordination” is a dirty word in G7 policymaking circles). And it was probably a good thing in the 1990s that Russia wanted to join the G7 – hence the G8 once a year, although many of the most important technical meetings are just the G7.

But today, honestly, what’s the point?

The L’Aquila summit seems likely to achieve nothing, i.e., nothing that could not have been agreed upon in a conference call among deputy ministers. Just because there’s a communiqué does not mean it has any real content. Does this kind of expensive pageant make politicians today look important or frivolous?

More broadly, three longer-run shifts mean the G7/G8 is increasingly anachronistic.

First, emerging markets have obviously risen in both respectable clout and ability to make trouble. China’s exchange rate policy is a leading example, but think also about Mexico, Brazil, or India. Having a global economic discussion (e.g., on climate change or aid to Africa) without these players fully at the table does not really make sense – particularly as the G20 now operates effectively at the heads of government level. And inviting these countries to a dinner or other event on the fringes of the main meeting just adds insult to injury.

Second, the Europeans are now organized into a loose political union and all of the major economies – except the UK – are in a currency union. What is the point of sitting down with Italy, Germany, France, and the UK separately? It is much more effective when they – and other Europeans – work out common positions and bring those to the table collectively. The European Union belongs to the G20 but not the G7.
Third, the idea that the US and its allies “lead” by any kind of economic policy example is plainly in disarray. The recent crisis focuses our attention, but we’ve seen two or three decades with irresponsible credit and throwing fiscal caution to the winds across these countries. These countries traditionally position themselves as “G7 models” worth emulating; this message needs to be toned down.

President Obama obviously has a talent for diplomacy (e.g., at the April G20 summit). He should use the Pittsburgh G20 summit in September to transition away from the dated emphasis on the importance of a G7/G8 heads of government meeting (e.g., reduce the excessive display of nothingness, lower the hype, have it feed into the G20 more explicitly). Canada, chair of the G7 next year and usually very sensible on these kinds of issues, can help.

The G7 is still a useful forum for senior staff meetings on some technical issues, but it would be much more appropriate and effective for the high profile pinnacle organization to be the G20, not the G7.

By Simon Johnson
Felix Salmon has been helping popularize Paul Collier’s idea of bankslaughter. (No, it’s not what you wish it were.) The idea is that there would be a crime called bankslaughter, or “managing a bank irresponsibly.” If a bank blows up, there could be a criminal investigation to determine if the bank managers behaved recklessly (more on that term later); if so, they would be convicted. The analogy is to manslaughter, which is actually a family of crimes; Collier probably means criminally negligent homicide, or causing death through negligent or reckless (more on those terms later) behavior.

Not surprisingly, the conservatives are not happy about this, even though it seems to conform to the conservative principle that people should bear responsibility for the consequences of their actions. (Or maybe that only applies if you are a pregnant teenager.) Salmon cites John Carney, who calls bankslaughter “the worst idea of the week.”

Here are some of his objections:

Collier doesn’t seem to have given much thought to the costs of over-deterrence. Bank executives faced with the prospect of a criminal investigation and possible conviction would likely be overly cautious. We’d lose a lot of socially beneficially risk taking by criminalizing bank failure.

There’s also a serious fairness issue. Only those executives whose risky bets blow up get investigated, prosecuted and punished. Those whose bets pay off are untouched. This means that being unlucky in the markets becomes a criminal matter. Criminality becomes a kind of lottery. . . .

Because bankslaughter is backward looking but conducting business is forward looking, it would almost certainly result in wrongful convictions. Lots of activity that looks reckless after the fact can seem perfectly sensible ahead of time. Unless the crime required bankers to know they were being reckless—in which case it would deter almost no-one and result in approximately zero convictions—it would wind up punishing bankers for just being wrong.
Regular readers can guess what I think of the idea of “over-deterrence.” We need some more over-deterrence. People can talk all they want about “socially beneficial risk taking,” but the evidence that this happened during the last thirty years is pretty contestable. For a system to have the optimal amount of risk taking, it is necessary (but not necessarily sufficient) that the people who stand to benefit from the venture internalize the risk of failure in some way; as everyone on the Internet has written multiple times, that condition did not hold for the financial sector in all sorts of ways.

But the more interesting argument is whether there is a problem with retroactively holding people liable for harm that they cause unintentionally. Carney writes as if this is just a crazy idea: first, only the people who actually cause harm are prosecuted, as opposed to others who behave equally egregiously but are lucky enough not to cause harm; second, it allows juries to evaluate behavior in the past with the benefit of hindsight.

What he doesn’t say is that this is exactly how a huge chunk of our legal system works today. It’s called torts, and even though I’ve only had one year of law school, and that was at Yale, where the joke is that you don’t actually learn any law, I know something about it. The general principle is that in most spheres of life, if you act negligently – defined to mean that you do not exercise the same degree of care a reasonable person would under the circumstances – and your action causes injury to someone else (to whom you owe a duty of care), you are liable for that injury. In some areas, the threshold is lower; for example, in product liability, the rule of strict liability applies, which means that you don’t even need to be negligent; if your product hurts someone, you’re liable. In other areas, the threshold is higher, and the requirement is not just negligence, but gross negligence, or willful wanton recklessness, or something like that. But that’s the basic principle; you don’t need intent, and the legal system certainly does assign liability after the fact.

So, for example, if you take a turn too fast on a wet road and you hit someone, you’re liable; but the twenty drivers ahead of you who all took the same turn too fast aren’t liable for anything. And juries decide whether you were being negligent with the benefit of hindsight; they know that the baby stroller was in the intersection, which you had no reason to know when you took the turn (and was highly unlikely, since it was late at night and raining). That’s just the way the law works.
Ironically enough, the modern tort system is a product of the second industrial revolution of the late nineteenth century, and was designed to cater to the needs of large businesses. By creating an objective, supposedly predictable and stable standard of negligence, it made it easier for businesses to manage the risks of their operations. And while there are certainly things they criticize, tort law is one of the main areas where the law-and-economics crowd has won out, and real judges actually talk about things like “cheapest cost avoiders.” For many scholars and jurists, the standard of reasonable care is defined as the degree of care such that the marginal benefit of accident avoidance equals the marginal cost of care; you can see how, in a tautological way, this creates a Panglossian “best of all possible worlds,” since it yields the perfect degree of deterrence. And the reason most economist types (and free marketers) like this way of thinking about tort law is that the whole point of the law is to create the right incentives without the need for all sorts of detailed regulation.

So Carney’s idea that this type of liability would produce over-deterrence is a bit curious. To get optimal deterrence in the bank-management context, you want managers to take precautions (e.g., maintain capital reserves) up to the point where the marginal reduction in the risk of a collapse is balanced by the marginal cost of those precautions. Today, we have no such thing, since we have no meaningful risk of collapse for bank managers, since their downside (relative to their upside) is limited by (a) leverage, (b) the implicit government guarantee, (c) the bonuses they got in the good years, and (d) the “resume put.” Because there is no liability for blowing up a bank, our legal system provides no deterrence whatsoever, which is one reason why we need regulation. (In a perfect law-and-economics world, you wouldn’t need regulators, since the threat of liability would create optimal behavior all by itself.)

Now, I don’t think that Collier has all the details right. First, I think that criminal prosecution for mere negligence is overkill; civil liability would be plenty, since that way you could go after all of the negligent manager’s assets, including his bonuses from the good years. We could save criminal prosecutions for people who commit actual fraud. Second, Collier uses “recklessness” and “reasonableness” as perfect opposites, which, from a legal standpoint, they’re not; you can fail to behave as a reasonable person would (that’s negligence) without your conduct rising to the level of recklessness.
The thing standing in the way of a civil version of bankslaughter is the business judgment rule, which basically says that if you are a manager who makes an informed decision in a situation where you do not have a conflict of interest, you are not liable, period, no matter how risky or stupid that decision is. And as far as I know, no court has ever held that having a bonus tied to your company’s stock price, with no commensurate downside risk, counts as a conflict of interest (even though it is). The point of the business judgment rule was to enable managers to take risks without fear of liability (or to enable rich people to sit on boards of directors and become even richer doing very little work without fear of liability). But in an environment where it’s very clear that managers were taking too many risks, because there was no way they would suffer the potential consequences of those risks, one very logical and sensible solution is to turn the dial partially back the other way and increase liability, which I see as Collier’s basic point. Since the business judgment rule is basically common law, it could be pared back by statute, and it could be pared back selectively – for example, for businesses whose blowups can have large societal costs.

One weakness of the Obama Administrations financial regulation proposal is that it doesn’t increase real costs for the key actors – bank managers and directors. Instead, it relies on better regulation enforced by better regulators. A civil version of bankslaughter could help fix this problem.

*By James Kwak*
Richard Thaler has a simple argument for plain-vanilla financial products. Mike at Rortybomb deals with some of the predictable objections. This is also similar to Adam Levitin’s position on credit cards, which I wrote about a while back.

I’m in favor, although I don’t think it will be enough to simply make the vanilla offering available; in that case nothing would stop lenders from paying higher commissions to brokers in order to steer customers toward exploding mortgages.

By James Kwak
Old Whine in New Bottles: Commercial Real Estate Lobbies For Bailout

Simon Johnson  | 09 Jul 2009

The commercial real estate industry would like a bailout – see my preview/links to testimony before the JEC today. This is not a surprise – even some of the most libertarian people I meet think the government should help them personally when times are bad. Is there a case treating commercial real estate as special?

The sector is definitely taking a beating, but who is not? This lobby’s most sophisticated advocates are arguing that various Fed facilities can be extended to support commercial real estate financing, i.e., so there is no cost to the government’s budget or your future taxes.

This is illusory.

We cannot have the Fed indefinitely take over the provision of credit to most of the economy. Asset prices need to fall and, if necessary, debts have to be restructured. This is easier, generally, for commercial real estate developers and operators than it is for residential mortgages.

The global crisis is surely not finished, but we are out of the panic phase. There is little compelling reason to provide “emergency” financial support to anyone at this point.

The price of retail space is falling because consumers are spending less and retailers are contracting or going out of business. This is painful and will turn around only when consumers figure out the new (higher) level of savings they want. We are already cushioning this blow with a big increase in public spending and a difficult future for public debt issues.

Going further for commercial real estate specifically is not appealing. If we do it for them, why not for everyone?

Of course, if commercial real estate worsens considerably, we will see further damage among banks. But didn’t the government stress tests assure us that the banks have enough capital to handle even worst case scenarios?

By Simon Johnson
In honor of Mark Sanford and that other guy from Nevada, the fun-loving crowd over at Planet Money has been talking about the economics of adultery, and even got Simon to comment for them. I’m all in favor of a cute model, but I think this is as much a sign of the over-expansion of economic reason as anything else.

Chana Joffe-Walt’s post asks this question of the typical cheating politician: “Didn’t he know he’ll get caught, put his family through hell, exhaust all of us with the details and jeopardize his career? The costs are so great, how could the affair possibly be worth it?”

Well, that assumes that he was going to get caught, and the odds of being caught in an affair are one of those things that are inherently very difficult to measure (and that cheaters are likely to underestimate, because of selection bias). We can see the numerator, but we can’t see the denominator. It also assumes that trading your political career for a steamy affair is a bad outcome. On some level, don’t you suspect that a lot of male politicians do it because they want to impress women, and that affairs are part of the payoff of politics? And what sane person would really want to be in electoral politics anyway?

More generally, the motivations that drive people to want to have sex with people they are not married to, or otherwise live secret lives other than the one they are supposed to live, seem to me not only too complex for a Chicago-school rational-actor model, but even perhaps too complex for a behavioral model. That is, I suspect that this type of behavior involves multiple actors inside the same person: one person who combines the ambitious, values-touting politician; the typical middle-aged man going through a midlife crisis and hoping for someone to validate his self-image; and, of course, the lout who thinks with something other than his brain. I think combining those sides of the psyche into a single utility model and maximizing it subject to a budget constraint (be it money or time) is basically a fantasy. But economists these days will stop at nothing.

*By James Kwak*
People Who Think Taxes Will Have to Go Up

James Kwak  |  10 Jul 2009

David Leonhardt has started a new club, which has already attracted some additional members.

Count me in, in spirit at least (there must be dozens of more prominent people for the Times to bother with). Because, ultimately, I think we Americans are a decent people (or at least a squeamish people), and we will not be able to endure the sight of millions of seniors being thrown onto the streets or deprived of medical care. And so the looming combined shortfall of Medicare, public pensions, private pensions, and individual savings will at some point motivate us to raise taxes on ourselves.

By James Kwak
Speculators ‘R’ Us: The G8 And Energy Prices

Simon Johnson | 10 Jul 2009

The G8 summit was obviously disappointing, even for those with low expectations. Usually, the substance is lacking but the public relations are well managed. This year even the messaging was messed up - they said some new things on climate change but not what we were told they could say, the food aid/development package was lamer than advertized, etc. So the whole thing looks like an expensive flop.

But actually it was much worse.

I’ve written elsewhere this week about the G8’s broad decline in legitimacy and appeal relative to the G20, and the specific pressing issue of cross-border resolution authority for failed banks – which is a matter of pressing urgency, yet not something taken up in or around this summit.

Think now about the macro/financial angle. Writing in the WSJ on Wednesday, Gordon Brown and Nicolas Sarkozy argued that speculation in financial markets lies behind the fluctuations in oil prices. The G8 went along with this message.

On any given Friday, I’m perfectly willing to believe that there are either specific manipulations or broader structural issues with regard to trading in oil futures. I welcome the CFTC’s moves to (finally) regulate markets more effectively.

But, more generally, the G8 – and its members this week – are disingenuous when they speak about energy prices, in three ways.

1) They are trying hard to talk up the market, with regard to global growth. At the same time, the hard data continue to disappoint. Naturally, this causes volatility in oil prices.

2) They claim to see no link between their failure to converge on climate change/environmental policies and what happens to energy prices. The extent to which industrialized countries’ effectively control carbon emissions will have a big impact on the longer-run demand for oil. Flip-flopping on this issue discourages investment in the energy sector (regular and alternative), and thus directly and indirectly contributes to oil price volatility.

3) The very cheap money policies of leading central banks, including the Fed, the Bank of England and arguably also the European Central Bank, lower the funding costs for big players who want to take large
positions in commodities markets. Essentially, we are providing the credit that makes big speculative positions possible. Add to this mix a “too big to fail” attitude and a “yes we can, recapitalize through trading profits” deal with policymakers, and you see why major financial firms are likely to place huge commodity bets in the months ahead.

The G8, separately and jointly, destabilizes energy prices and refuses to even talk about this reality – taking the view that being more candid would just upset consumer, business, and investor confidence. They gamble, on energy and more broadly, that the road to recovery runs parallel with pretending there are no problems.

The true speculators here are your elected representatives.

*By Simon Johnson*
The Future of Computing?

James Kwak | 10 Jul 2009

Google announced the Google Chrome “Operating System” a few days ago, and the world I used to live in is abuzz with people talking about the earthquake this represents for the computing industry. TechCrunch says, “Google Drops a Nuclear Bomb on Microsoft.” Leo Babauta of Zen Habits has a more thoughtful response, but also subscribes to the “future of computing” theme: “Google is moving everything online, and I really believe this is the future of computing. The desktop model of computing — the Microsoft era — is coming to an end. It’ll take a few years, but it will happen.”

The basic idea is that the future is all about connectivity. All your data and apps will be in the sky (on servers that you can access from anywhere). And, according to Babauta, the way we use computers is also changing:

While the business world has long used Microsoft Word to create rich documents full of formatting and charts, the increasingly mobile world doesn’t care about any of that. We send emails and text messages and tweets and messages on Facebook and forums and other social media — with no formatting at all. We do blog posts that have bold and italics and links and photos and videos and not much more in terms of formatting text.

We don’t need feature-bloated Microsoft Word anymore. Nor Excel, with its 2 million features, nor PowerPoint (who likes to watch slides?). Sure, there are still some great desktop apps that people use, for photo and video editing and much more ... but the majority of us don’t need those. We need to communicate simply and quickly, without hassle.

I’m sympathetic to this picture, in part because I work on several different computers at different times. I already store a lot of my information on the Internet (including all my law school notes, which are accessible to all my classmates); I use web apps where feasible, including Gmail, Google Calendar, Google Docs (for lightweight work), Google Reader, Google Sites, Flickr, this blog, and so on. But I think there are a couple of holes in this story.
The small hole is that Google Chrome OS just doesn’t add up for me (even though Google Chrome is my favorite browser). In the old parlance, it isn’t even an operating system; it’s what used to be called an “operating environment.” The OS is Linux; Google Chrome OS is just the layer on top that you can see and touch.

More importantly, Google Chrome OS looks to me like a crippled version of Ubuntu (a popular desktop flavor of Linux), which is also free and open source. I recently installed Ubuntu on an old laptop, and I mainly just use the browser (Firefox). But if I need or want to use other applications on the laptop itself, I can; for example, if I’m doing some blogging and I want to download some data into a spreadsheet, I can. (Don’t try telling me that Google Docs has a spreadsheet program that’s usable for anything other than adding and subtracting, at least not yet.) Or I can play MP3s via the MP3 player, instead of having to stream them from some web site. With Google Chrome OS, all I’ve got is the browser. The only compensating advantage I can think of is that it should start up faster than Ubuntu, but since Ubuntu rarely needs to be rebooted, that doesn’t matter much.

The big and more interesting hole is that all this “future of computing” talk should come with an asterisk, with a note saying: “Applies only to personal computing by consumers with limited needs.” The technology media tend to think that the state of computing is reflected in the tools that they use: netbooks, built-in 3G wireless, Gmail, Facebook, Twitter, Amazon, eBay, etc. But I would submit that the computing that really matters is the kind that goes on inside companies.

Brad DeLong recently cited Robert Allen on the central role of “productivity-raising machinery” in the transformation of the first industrial revolution into the second industrial revolution and a virtuous cycle of continuous improvement. Recently, people have talked about computer technology playing a similar role in boosting productivity across the economy, although on a smaller scale. But if computers are going to increase productivity and thereby our standards of living, it is not (or not primarily) because they make it easy to create and view pictures of cats with misspelled captions, entertaining though that is.

And there, where it really matters, at least from a macro-economic perspective, the future of computing is a long, long way off. If you hypothesize a uniform unit of “work” done by computers used in businesses – and I mean useful work accomplished, not calculations performed – all of my own observations indicate that the vast majority of
this work is still being done by old-fashioned mainframe computers, and most of the rest is being done by those much-hated “client/server” systems.

I’m willing to allow the possibility that in some areas like manufacturing it’s possible that computers have made possible huge amounts of productivity-increasing automation. But in the mass services industries that I’m more familiar, like insurance, the efficiency gains provided by computers have been limited. Think about every time you have tried to do something simple at an airport – like change your frequent flyer number – and watched as the agent typed code after code after code. Or all the times your customer service representative couldn’t answer the simplest question on the phone. My company, which does something so boring no technology writer would ever dream of writing about it, has been pretty successful because we picked an industry that was vastly underutilizing or misusing technology, and we built systems that, while far better than anything our customers had before, are not at the bleeding edge of software.

The big problem in the way most large companies use computer technology is not the software per se; it’s the complexity of conceptualizing, designing, building, and testing huge applications involving millions of lines of code to manage business processes in new and better ways, when those new and better ways can only be dimly glimpsed from the perspective of the current situation. Planning and running these projects is something that most companies are admittedly bad at. The example closest to the usual themes of this blog would be the failure of the mortgage servicing companies to get their modification programs off the ground, in part because they can’t get the systems and processes in place quickly enough. But this happens over and over again in virtually all large companies.

And for me, this is actually a reason to be hopeful. The potential for information technology to improve productivity is still enormous, and we don’t need netbooks or cloud computing or new operating systems or quantum computers to get there. The hardware and software tools of today – or of five years ago – would work just fine, if companies could figure out how to apply and implement them successfully and repeatably. From the point of view of the economy, whether college students are using Windows, OS X, Linux, Android, or Google Chrome OS in five years really doesn’t matter.
I don’t think the people talking about Google Chrome OS would actually disagree with this; they’re just more interested in knowing what tools they will be using in the future. But given that our economy has to figure out some way to increase productivity growth for the long term, the important question is whether companies will figure out how to use existing technology more effectively. The information technology industry is very, very immature. It can improve a lot.

By James Kwak
Larry Summers’ New Model: Details, Contradictions, And Odd Assumptions

Simon Johnson | 11 Jul 2009

Larry Summers had “lunch with the FT” (p.3 in the Life and Arts section today) – although unfortunately the paper does not report when this happened; a week or two makes quite a difference these days.

Putting this next to his April speech to the IDB, Summers’ view of the way forward has a few problems.

Summers says “The American problem this time has more in common, at least qualitatively, with the Japanese post-bubble problem, where the issue was not reassuring foreigners but maintaining sufficient domestic demand to push the economy forward.”

But Japan had a chronic current account surplus, which became bigger as firms saved more in order to pay down their debts during the 1990s. The Japanese government could finance its deficit domestically – and the country exported capital consistently. In contrast, with our well-established and large current account deficit and our eye-popping budget deficit, we rely much more on the confidence of foreigners – unless Summers is assuming that the increase in our private sector savings will be truly enormous.

As Summers says, quite accurately, the Asian and other crises of the late 1990s,

“… took the form of a foreign lack of confidence in a country that led to a mass withdrawal of funds and made reassuring foreigners the central priority. That’s why interest rates often had to be increased.”

Surely, we face some sort of hybrid Japan/emerging market crisis. Or perhaps we are heading towards blending Japan in the 1990s and the US in the 1970s, i.e., there has been a permanent shock (oil then v. financial sector now) to which we should adjust, and if we attempt to postpone that adjustment excessively through overexpansionary macro policies, we’ll experience a great deal of inflation.

On Japan in the 1990s, Summers is famous for first arguing it was an aggregate demand problem and later coming to the view that the banks were undercapitalized and – without this – the economy could not
sustain a recovery. His ideas on the US are likely to go through the same evolution.

It is also striking that he makes no mention of balance sheets problems, either for consumers or businesses – in Japan then or the US now. It sounds like he is getting ready to push for a second fiscal stimulus – actually, for him this would be the third stimulus, as he argued hard for the tax cut stimulus of early 2008.

Summers is almost certainly wrong when he says, “The very great enthusiasm for accumulating reserves that one saw globally is likely to be a smaller factor over the next decade than it has been in recent years.” On the contrary, most emerging markets are glad they had more reserves than in the past and are now wondering about how to build up those reserves further. This may, of course, help the US sell some of its forthcoming government debt – but it doesn’t reduce “global imbalances” or address the fact that we are on an unsustainable public debt and foreign debt path. Most of all, it lets us dig a deeper hole for ourselves and for the world economy.

More broadly, Summers continues to argue, at least implicitly, that we face a temporary shock or one-off aberration of some kind. He distinguishes sharply “fixing” the banking system and “getting the economy out of the rut” from long-run issues, “like fixing health-care, like having real energy policy, like reforming education.” He apparently does not see much by way of connections between these two sets of issues.

But doesn’t the economic and political power of our troubled banking system threaten our longer run opportunities? Aren’t our nonfinancial reform options (e.g., on universal healthcare coverage) already limited by the doubling of government debt (towards 80% of GDP) we are undertaking as a direct consequence of financial sector misfeasance? And won’t Medicare – and much else – be undermined by the behavior of “too big to fail” banks down the road?

Summers has commendably switched some of his rhetoric, so now he emphasizes nonfinancial technology development – presumably in the private sector – as the road to sustainable growth. And he rightly contrasts this with the financial engineering that brought us to this point. But does his model really offer the most plausible or appealing path from here to there?

By Simon Johnson
How to Win Friends and Influence People

James Kwak 12 Jul 2009

An old friend of mine asked me for some advice about how to increase readership for his blog. I was going to write him a long email, but I thought if I put it here other people can chime in as well.

The conventional wisdom about how to make your blog successful is “write great content.” Of course, that’s very self-serving for established bloggers to say, since it implies that they write great content. I think Felix Salmon is more accurate: write a lot of content.

Should you write more, with lower quality, or less, with higher quality? Fortunately, the blogosphere has been around for long enough that we have a simple empirical answer to this question: given the choice, go for quantity over quality. You might not like it — I certainly don’t — but I defy you to name a really good blogger who doesn’t blog frequently . . . .

Mostly, blogging is a lottery on the individual-blog-entry level — and if you want to win the lottery, your best chance of doing so is to maximize the number of lottery tickets you buy.

(Of course, we at The Baseline Scenario don’t follow this rule, but if I had more time I would.) I recommend Felix’s whole post, most of which I agree with. But I’ll add a few thoughts of my own.

The first thing I should say is that I could be completely wrong about everything that follows. Apart from my dog’s blog, and the personal blog I no longer have time for, and my internal company blog, I’ve only been doing this for ten months. And it’s possible that our readership is based entirely on two things: (a) Simon’s popularity with the media; and (b) luck (being noticed by Paul Krugman). Also, I have no data to back up anything I say. With that in mind . . . .

For any blog, the primary source of traffic is other blogs. That means your immediate goal is to write posts that will be linked to by other bloggers. First, you should be aware of who those other bloggers are. In my world, that would be Calculated Risk, Paul Krugman, Tyler Cowen, Brad DeLong, Mark Thoma, Econbrowser, Felix Salmon, Tyler Durden, Ezra Klein, Rortybomb, etc. Obviously, some of them are bigger than others; one link from Krugman is worth one hundred links from most other people. But you can’t pin your hopes solely on Krugman or
Andrew Sullivan or Atrios. In particular, I imagine that those guys use other blogs as filters to decide what they should read; for example, I recall Krugman saying that he reads Mark Thoma because Thoma is a great way to find out what lots of different people are saying. So you should be aware of the whole community, or as much of it as you can keep track of.

You should read these other blogs so you can be aware of the issues people care about. It’s good to write about issues that other people are interested in at the moment – right now in the economic policy world, that would be financial regulation, health care, energy policy, and increasingly the debate over a second stimulus – but it’s also important to have an original perspective on those issues. Because if Krugman makes an argument on Monday, and you make the same argument on Tuesday, even if your post is better, it’s unlikely to be cited (unless Krugman triggered an ongoing debate). It’s even better to have a unique voice – a point of view that people will recognize as distinctively yours and that they can’t get anywhere else. This is pretty hard, and I’m not sure we’ve accomplished it. But it’s important, because almost without exception, any information on your blog can be found elsewhere; people will only come back because they want to hear you.

How do you get your blog noticed by other blogs? One simple way is to just email them and introduce yourself. There is no downside to this approach, even though it may not work all the time. But all the bloggers I know do read their email, even if they don’t have time to respond to all of it.

It is also somewhat common to email people and ask for a link on their blogroll. I don’t particularly recommend this, because I think blogroll links have little value; if I read Blog A, I will follow links in posts on Blog A, but I am unlikely to click over to another blog just because it’s in Blog A’s blogroll. (My perspective may be skewed because I do most of my reading in Google Reader, so I don’t even see the blogrolls.) But there’s no real harm in asking, although I suspect some bloggers may be annoyed by it.

Another way is through the comments. Most bloggers read their comments, and if you have insightful things to say, they will notice you. Some people will write a post on their own blog, then go to Big Blog and write a comment that links back to their own post. I used to do this on occasion. My feeling is that if your post really does address the issues in the original post on Big Blog, that’s fine, but you have to put more than
just a link or no one will follow it. What matters is not your post, but what you write in that comment. If I am impressed by a comment, I will follow the link; if I’m not impressed by the comment, I won’t bother. Whether there is a link or not really doesn’t matter; most blog comment systems (like WordPress.com, which we use) allow you to link a URL to your name, and if I find myself reading your comments repeatedly, I will check out your blog. There are at least three blogs that I became aware of and have linked to (here or in Twitter) because their authors commented here: Nemo, Rortybomb, and Taunter. (And once when I put a link to Nemo in our Twitter feed, it led to a chain of events that eventually brought his server down.) I also list the blogs of some of our more loyal commenters in the sidebar, but that’s relatively unusual as far as I can tell.

Probably the most common to get attention from other bloggers is to link to them. Most of us have some way of seeing who is linking to us. And though it isn’t logically necessary, if you link to other people, they are more likely to link to you. It’s just human nature. It’s also good form in the blogging community; if you read about a good idea, you should give credit to the person you got it from. Put another way, if you write a “blog,” but you only write standalone essays that have nothing to do with the rest of the blogging community, then from our standpoint you’re not a blogger; you’re just like an op-ed writer for a newspaper. And while we do cite newspaper op-eds, we cite other blogs more often.

Once you have some bloggers reading your blog, then ideally things will snowball. As I said, Krugman may not read your blog, but he reads Thoma, and Thoma reads everything. There is certainly a herd mentality among bloggers; if your name starts popping up on a few different blogs, then all the other bloggers will come looking. But there’s no way to estimate how long this will take; as Salmon said, whether a particular post gets noticed is largely a lottery, and I certainly can’t predict which of my posts will become popular.

One thing that follows from this is that it’s important to make it easy for other bloggers to read your blog. Here I (again) agree with Felix Salmon: publish a full RSS feed. The short reason is that I suspect most bloggers read other blogs in their RSS readers, and if I have to click on a link to read a full post, then those first few lines have to be really interesting, or I won’t make the click. Speaking for myself, I am much more likely to read a post on a blog that gives me a full feed than one that doesn’t, even though the latter category includes Krugman, FT Alphaville, Economix, and many other worthwhile blogs.
Dave Winer, however, disagrees in a comment on my earlier post; he prefers that the RSS feed include a summary rather than full text. And Dave Winer is one of the fathers of RSS, so he knows whereof he speaks.

Another thing that follows, though perhaps a little less obviously: be polite. Bloggers are a community, and how you behave matters. If you disagree strongly with someone, express your disagreement through superior logic or mountains of evidence, not by calling the other person an idiot. There are a few bloggers out there who not only like to show that they are smarter than other people (most of us fall victim to this temptation), but come out and say that they are smarter than other people, and judging from their traffic (Alexa can show this for you) that strategy has not been successful for them. I am on good terms with some of the people whom I have disagreed with most strongly; some of them send me emails pointing out posts they think I may find interesting. Bloggers are people like everyone else; whether they will help you depends largely on whether they like you.

Besides building credibility and relationships with other blogs, my other big piece of advice is to make your blog as sticky and as easy to find as possible. Someday you may get a link from Krugman or Sullivan, and your page views will skyrocket. But you want those people to come back again and again, so when they show up, your blog should make that as easy as possible. That’s why we try to make it as obvious and easy as possible for people to sign up for emails or to subscribe to our RSS feed (we use Feedburner). You should also assume that your readers don’t know what RSS is and tell them why they should use it. Because if they don’t subscribe, they probably won’t be back. If you can put the box for people to enter their emails and click submit on your blog’s template (so it appears on every page), that’s even better.

Being easy to find also means putting it where people want it. That may mean Facebook or Twitter, no matter what you personally think of Facebook or Twitter. It can also mean republishing your blog on aggregator sites, such as Seeking Alpha or RGE Monitor (although the latter may be by invitation only). The important thing is to get your name and your articles out there so people (especially other bloggers) can find them.

And if you are ever on the radio, make sure to ask the host to give out your blog’s address over the air. It can’t hurt.

As I said, other people are welcome to add their suggestions below.

By James Kwak
Who Is Upton Sinclair? (Weekend Comment Competition)

Simon Johnson  | 12 Jul 2009

By 1906, it was obvious to many people that the industrialization of food production in the United States had brought with it some unpleasant and even unsafe practices. Consumers were definitely not getting exactly what they thought they were getting.

But efforts to reform the industry – and to protect consumers – were mired in the power of this lobby (with strong political power based on its great economic power), the resilience of laissez-faire ideas, and the intransigence of powerful individuals in the Senate. There were legislative proposals, but the overall reform agenda was not really going anywhere fast.

Then Upton Sinclair published The Jungle. No one could look at meat packing or its products in the same way again, and this directly and immediately helped produce stronger federal legislation regulating the industry.

So who is our Upton Sinclair and when will they write the definitive piece that captures imaginations and changes the terms of the debate? Is it about how consumers were mistreated, politicians captured, or the public treasury ransacked? Will it be a novel or nonfiction?

Or perhaps it is a movie, with all the modern Hollywood marketing techniques and tie-ins?

By Simon Johnson
Waiting For The Big Push: Selling The Consumer Protection Agency For Financial Products

Simon Johnson | 13 Jul 2009

In mid-March, the administration proposed that toxic assets could and would be safely removed from banks balance sheets. We were skeptical, and the the PPIP now seems to have slipped into irrelevance (loans; securities). But the administration still put an impressive effort into persuading independent analysts, and broader public opinion, that they should do something clearly beneficial for banks. This was “all hands on deck,” and it definitely had an impact on the debate, at least for a while.

Now, the administration’s major remaining initiative is its version of a Financial Product Safety Commission - something that would be clearly beneficial for the public. And the skepticism – and outright opposition – comes from the banking sector.

How does the administration’s effort compare, then vs. now?

As far as I can see, they are not pushing this new consumer protection/safety agency hard enough.

Some sources claim that Secretary Geithner is fully on board with the Agency, and certainly he has mentioned it in public. But there is no sign of the frenzied effort that accompanied efforts to launch the PPIP – when, for example, almost every economist in the administration seemed pressed into service to call potential critics and ask them to “give it a chance.”

One symptom of this “effort gap” is that counter-arguments and disinformation about the proposed agency begin to gain the upper hand. One senior executive recently told me that this agency would have unprecedented powers to determine the decision of individual products – “something not even the FDA can do.”

Of course, this is nonsense. The new agency would be powerful – and thus it is feared by the industry – and presumably it would be able to prevent sufficiently toxic products from being sold. Hopefully, it will also be able to require that all financial institutions also offer some vanilla products, to make consumers’ choices easier. But the idea that an agency would design the details of all products for any sector is both implausible and a malicious rumor being spread by opponents (actually, it reminds me of the pushback from meatpackers, and others, early in the 20th century).
If Treasury is so supportive of this new Agency, now is the time to launch public, high profile, and clever counterattacks. By the time the legislation is being voted on, it will be too late.

And in this context, the administration should push hard on one of the great ironies here. Financial sector executives like to stress the importance of “consumer confidence,” and they urge the government to take steps to restore this confidence (e.g., with a straight face, suggesting even more really cheap credit from the Fed to their favorite sector.)

But the same people completely reject the idea that consumers will feel more confident about financial products if there is finally some serious consumer protection around those products. Whenever people learn – or just fear – that a particular food product is unsafe, they stop buying it. When the stock market ripped people off in the late 1920s, it took legislation with real teeth to rebuild investor confidence – take a look at, for example, the Securities Exchange Act of 1934. And the entire edifice of modern medicine is based on the idea that someone in government will make the call, right or wrong, on whether a compound can be regarded as a helpful drug – as opposed to colored water or something actually poisonous, which is what was sold as “patent medicine” 100-150 years ago.

If Treasury and the administration really wants a Consumer Protection/Safety Agency for finance, they need to kick their support campaign into much higher gear immediately.

By Simon Johnson
How to Back Up the Shadow Banking System

James Kwak  | 14 Jul 2009

Mike from Rortybomb has an interview with Perry Mehrling on the shadow banking system. I was going to try to put this in some context, but Mark Thoma (who played an important role in this saga) beat me to it.

Mehrling’s takeaway point is that there needs to be a “credit insurer of last resort,” who will insure any asset against a fall in value – for a sufficiently high premium. This would make it possible for financial institutions to unload the risk of their asset portfolios in a crisis, if they are willing to pay enough to do so. The only institution that would have the credibility to play this role in a real crisis would be the federal government; as we saw, AIG – the world’s largest insurance company, remember – was not up to the task. Still, though, I’m not sure this would do the trick. If I’m a large bank with a balance sheet full of toxic assets, and I don’t want to pay the premium that the insurer of last resort is charging, then I go to the government, say the price is too high, and ask for a bailout. The credit insurer of last resort would need to be coupled with a commitment not to provide an alternative form of government support, or we would end up where we are today.

By James Kwak
The Problem with Software

James Kwak  | 14 Jul 2009

Phillip Longman has an article on health care information systems with the provocative title, “Code Red: How software companies could screw up Obama’s health care reform” (hat tip Ezra Klein). The argument of the article goes something like this. One, the health care cost problem is largely caused by overtreatment. Two, the answer is software: “Almost all experts agree that in order to begin to deal with these problems, the health care industry must step into the twenty-first century and become computerized.” Three, software implementation projects can go horribly, horribly wrong. Four, the solution is open-source software.

I have no argument with point one. And I agree wholeheartedly with point three. Anecdotally (but I have seen a lot of anecdotes), the median large-scale corporate software project goes way over budget, is delivered years late, is just barely functional enough to allow the executives involved to claim they delivered something, and is hated by everyone involved. But I’m not sold on points two and four.

On point two, I’d like to see some evidence, or at least an argument, that computerization actually leads to less overtreatment. I can buy that it reduces errors, and that it reduces the costs of delivering health care a tiny bit. But to help with the health care cost problem, software would have to somehow cause physicians to prescribe less of the sorts of tests and procedures that drive up costs in this country. And there I think that incentives (the more procedures you do, the more money you make) win out over technology any day.

On point four, Longman gives a standard argument for why open source software is good and “proprietary” software is bad. He contrasts Midland Memorial Hospital, which installed an open-source system developed at the VA and had great results (although there is no mention that overtreatment was actually reduced), with Children’s Hospital of Pittsburgh, which installed a proprietary system and had catastrophic results. But then he jumps ahead to his conclusion: “While many factors were no doubt at work, among the most crucial was a difference in the software installed by the two institutions,” and he focuses on the fact that one was open-source and the other was not.

I am a huge believer that some software is great and some software sucks. However, Longman believes two things I do not believe. First,
while good software is an important ingredient of a successful project, it is only one ingredient among many. I would put an experienced team, effective decision-makers, a flexible, realistic implementation approach, and a culture of quality up there along with good software. Most software projects fall victim not to bad software, but to the coordination problem – of having dozens of people working together on a single, intangible, unstable product – compounded by the motivation problem.

Second, I don’t believe that whether software is open-source or proprietary has much of an impact on whether it is great or it sucks. Open-source software is not necessarily easier to implement; for an analogy, compare getting a printer driver to work on Linux vs. Windows. Nor is it easier to modify, unless you happen to be highly skilled at developing in the language of the source code (and not even then, since modifying source code is inherently complex and risky). Nor is it necessarily cheaper, since software license costs are typically a very small fraction of total software project costs; by far the largest component is usually the manpower necessary to configure, integrate, and test the software. Some open source software is great, although most of it is at the platform layer (operating system, database management system, application server, web server, development tools) rather than the application layer; some no doubt sucks.

For the record, all things being equal, I always go for open-source software, and the two computers I own (but not my company computer) run Linux. But it is far from being the future of computing, as Longman claims:

Once the province of geeky software aficionados, open-source software is quickly becoming mainstream. Windows has an increasingly popular open-source competitor in the Linux operating system. A free program called Apache now dominates the market for Internet servers. The trend is so powerful that IBM has abandoned its proprietary software business model entirely, and now gives its programs away for free while offering support, maintenance, and customization of open-source programs, increasingly including many with health care applications. Apple now shares enough of its code that we see an explosion of homemade “applets” for the iPhone—each of which makes the iPhone more useful to more people, increasing Apple’s base of potential customers.
IBM abandoned proprietary software because their proprietary software wasn’t very good. The main business software companies, the ones who actually make big piles of money – SAP, Oracle, and Microsoft – are not planning to open-source their software anytime soon. And Apple has historically been the exact opposite of open-source. They are simply doing what Microsoft has always done – exposing enough of an interface layer so that third-party developers can write applications that run on Apple operating systems.

All that said, Longman may be right that in the health care delivery sector, the VA system, which happens to be open source, is better than any of the proprietary systems out there. In particular, once any system – open-source or proprietary – establishes a leading position in the market, it benefits from network-like effects that help it increase its lead on the competition. Simply because the VA system has been implemented hundreds of times, it should be cheaper and lower-risk than the alternatives. And the open-source development approach can lead to higher quality.

Longman is also right that proprietary technology vendors will typically have more marketing money and lobbying muscle to get their way, since open-source projects generally don’t have major financial interests behind them. This could lead to an outcome where the industry ends up using software that sucks instead of great software.

But I’m not sure the answer is to simply defer investment in software, as Longman proposes. The basic problem – that a lot of software sucks, that most buyers have difficulty finding software that doesn’t suck, and that most projects fail – is not going to go away. Maybe some of the money should be used to invest in new software startups to serve health care providers, although that’s hardly a guarantee of good software. Or maybe, if the VA system is so good, some of the money should be used to give it some marketing muscle, something like what the Mozilla Foundation is for Firefox. After all, on a level playing field, the best solution should win out.

Ultimately, though, I think it’s best not to pin too many hopes on software. As I said earlier, it’s not going to change physician incentives on its own. And getting a software project right is very, very hard, even with the best software. There’s no magic bullet here.

**Update:** One of our readers, who happens to be a VA physician, wrote in to say that one of the reasons he works there is “an impeccable IT system, the likes of which have not yet seen a rival.” So perhaps the VA
system really is better than anything else in the industry. If so, the government should be pushing providers to implement it. If the problem is that the VA system doesn’t have the marketing clout to compete with the private software vendors, then that’s the problem that should be fixed. I know a few former software people who might be willing to help, if it really is that good.

By James Kwak
Will CIT Go Bankrupt?

Simon Johnson | 14 Jul 2009

CIT Group is apparently in trouble and now negotiating with Treasury, the Fed, and the FDIC for some sort of “bailout”, e.g., in the form of a guarantee for its debt.

Traditionally, CIT provided vanilla loans to small and medium-sized business. “But under its current chief executive, Jeffrey M. Peek, a well-liked Wall Street veteran who lost out several years ago in a race to run Merrill Lynch, CIT made an ill-timed expansion into sub-prime mortgage and student lending” (NYT today).

What happens to CIT will help define exactly where we are with regard to “too big to fail.”

At the end of 2008, CIT had total assets around $80bn, which was about 1/10th the size of Goldman (and about 1/25th the size of Citigroup) and puts it just outside the top 20 publicly traded financial services company. Presumably, it just missed the cut for inclusion in the government’s recent “stress tests”.

Its assets are between 2 and 3 times those of the largest “hedge funds” – although obviously what gets that label these days is somewhat arbitrary, and the leverage in any individual fund could mean system risks roughly of the same scale as for CIT.

CIT’s bailout possibilities are now in the realm of political choice. The rest of the financial sector, including hedge funds and the American Bankers’ Association (ABA), should be lobbying for it not to get bailed out – otherwise the bar for “too big to fail” will be lowered (by roughly an order of magnitude), and there will be many more voices arguing that even medium-sized banks/funds need to be broken up or otherwise severely constrained.

However, given that hedge funds have no discernible political strategy – other than to cry in public about impending European regulation – we should not expect any coherent response from that quarter. And the ABA mistakenly thinks they can take on all comers on all issues; their hubris does not lend itself to thinking through this particular part of the chess game. So both of these powerful forces are likely to sit on the fence.

The decision therefore largely comes down to the administration. On this front, the lack of strong connections between CIT’s CEO and senior Treasury officials looks like a weakness. CIT seems to sit at the edge of
the charmed circle, with regard to meetings, shared social engagements, and intellectual entanglements. This is a close call, but I think it is just on the outside of the circle – in the sense that with the overall financial market situation more stable, the GM bankruptcy well-managed relative to expectations, and other credit support programs still in place, the balance of official opinion will tilt against CIT.

So then it all comes down to political donations. At least in terms of what is in the public record, Mr. Peek has not been overly generous, but he did give money to John McCain – and not to any Democrats. If this is in fact the limit of his recent contributions, I think you know the outcome.

*By Simon Johnson*
CIT Battlelines

Simon Johnson  | 15 Jul 2009

The issue of the day is obviously CIT. It’s hard to sort out the real news from clever PR/planted stories in this situation, but it looks like the FDIC is coming out strongly against being involved in a rescue package. Given Sheila Bair’s successful political positioning and strong popular appeal, it’s hard to see how – once dug in – the FDIC can be moved.

The lobbying frenzy has concentrated on CIT’s role in financing small and medium-sized business; “the recession will be deeper if CIT fails” is the refrain. This is a weak argument – it would be straightforward to refinance this part of CIT’s business without bailing out CIT’s creditors, and definitely without keeping top CIT executives in place; this is the essence of “negotiated conservatorship,” which is a proven model in the US.

More plausible is the concern that given Treasury’s generous handouts to date for financial firms, if they are now tough on CIT’s creditors, this will send a new signal about how they may treat other firms – and maybe raise fears of Hank Paulson-like flipflopping. Citigroup’s CDS spread is still at worrying levels, and Treasury/National Economic Council watches this closely – for both organizational and personal reasons.

Essentially, by trying to refloat an undercapitalized banking system, Treasury has created pervasive financial vulnerabilities to CIT-sized shocks. These are now the basis for more bailouts and even great fiscal costs.

If CIT is determined to be “too big to fail” in today’s context, this has far reaching implications. Instead of financial entities with assets of at least $500bn creating systemic risk, we now have to worry about anyone who has not much more than $50bn. This is a profound change – and a point that seems to have escaped the Financial Services Roundtable, which is pushing hard for a CIT rescue.

Mr. Geithner is travelling back from the Middle East today. Once he lands, I would guess that a bailout package will go through (on the weekend, if they can get that far) and creditors are unscathed. But I still suspect that there will be management change at CIT.

How the CIT deal impacts current Capitol Hill discussion on system risk and regulatory reform remains to be seen. The effects there could be more profound than expected.
By Simon Johnson
Some discussion of these issues with TNR is here.
The Man Who Crashed the World?

James Kwak | 15 Jul 2009

Back in November, Michael Lewis wrote a great story in Portfolio on the financial crisis, focusing on the traders who saw that the housing bubble was going to crash, bringing mortgage-backed securities down with it – and made lots of money betting on it. Now Lewis is back with his article in Vanity Fair on AIG Financial Products (FP) and its last head, Joseph Cassano. This time, though, it feels like it’s missing the usual Lewis magic.

Lewis sets out to tell the untold story of FP, based on extensive interviews with people who actually worked there. He starts by laying out the conventional wisdom about FP, which presumably he is going to debunk. The conventional wisdom, according to Lewis, is that the problem lay in credit default swaps: “The public explanation of A.I.G.’s failure focused on the credit-default swaps sold by traders at A.I.G. F.P., when A.I.G.’s problems were clearly much broader.” Indeed, Lewis implies that the government essentially framed FP: “Why were officials, both public and private, so intent on leading others to believe all the losses at A.I.G. had been caused by a few dozen traders in this fringe unit in London and Connecticut?

The problem is that, having actually paid for the magazine and read the article, it seems to me that Lewis only reinforces the case against FP and credit default swaps. He says that all of the FP people he talked to “were fairly certain that if it hadn’t been for A.I.G. F.P. the subprime-mortgage machine might never have been built, and the financial crisis might never have happened.” That sounds to me like a more damning case than I would have made.

In Lewis’s story, it was credit default swaps sold by FP that enabled banks to issue securities backed by subprime mortgages earlier this decade. He has evidence that the people at FP who were insuring these securities had no idea how much subprime debt was inside them. When Gene Park figured it out around the end of 2005, Joe Cassano actually agreed to stop insuring subprime-backed securities. Yet Lewis even holds FP responsible for what came later:

“A.I.G. F.P.’s willingness to assume the vast majority of the risk of all the subprime-mortgage bonds created in 2004 and 2005 had
created a machine that depended for its fuel on subprime-mortgage loans.

“The big Wall Street firms solved the problem by taking the risk themselves. . . . Unwilling to take the risk of subprime-mortgage bonds in 2004 and 2005, the Wall Street firms swallowed the risk in 2006 and 2007.”

This is somewhat plausible, but it’s a funny argument. Essentially it says that: (a) FP was responsible for subprime lending because, without insurance, investment banks wouldn’t have been willing to take on the risk of the securities in the first place (and demand from investment banks is what caused frontline lenders to originate these loans); but (b) when FP stopped insuring the securities, investment banks suddenly decided they were willing to take on the risk. I say it’s plausible because it could be that FP enabled a profit machine in 2004-05 and the banks were unable to shut it down in 2006-07 without torpedoing their earnings. But if that were the case, they would all have behaved like Goldman – shorting the mortgage-backed securities markets with one hand at the same time that they originated the stuff with the other. In 2006-07, most banks simply underestimated the risk of the stuff they were holding; that is FP’s fault only if you claim that FP made banks like Bear and Lehman stupid.

So when Lewis says, “A.I.G. F.P. wasn’t an aberration; what happened at A.I.G. F.P could have happened anywhere on Wall Street . . . and did” (ellipsis in original), I’m not sure which side he is arguing. Is he saying that FP is to blame for the crash? Or is he saying that FP caused the crash, but doesn’t deserve to be singled out because it “could have happened anywhere?”

The latter argument, to me, doesn’t make sense. The problem is better illustrated when Lewis describes the rise of credit default swaps in the 1990s:

“The traits required of this corporation were that it not be a bank – and thus subject to bank regulation and the need to reserve capital against the risky assets – and that it be willing and able to bury exotic risks on its balance sheet. There was no real reason that company had to be A.I.G.; it could have been any AAA-rated entity with a huge balance sheet. Berkshire Hathaway, for instance, or General Electric. A.I.G. just got there first.”
I don’t think anyone has ever argued that for some structural reason AIG was the only company that could have created the mess it did. AIG created the mess because it made stupid business decisions that other companies did not make. Other companies made other stupid decisions, but not the one to take a huge, one-sided bet, with no reserves, on the solidity of the housing sector and the entire economy.

Ultimately, I think Lewis is actually too harsh on FP. They made bad decisions, they essentially blew up all of AIG, and they required an enormous taxpayer-funded bailout to limit the collateral damage. But holding them responsible for the bad decisions at all the Wall Street investment banks seems a bit much.

By James Kwak
WSJ Editorial Page Favors “Bailout Tax” on Large Financial Institutions

James Kwak  | 15 Jul 2009

I had a post criticizing John Carney on the topic of bankslaughter. However, I must say I agree with him when it comes to Goldman Sachs. Even more surprising, I largely agree with the Wall Street Journal editorial that Carney links to.

Here’s what the Journal has to say:

We like profits as much as the next capitalist. But when those profits are supported by government guarantees or insured deposits, taxpayers have a special interest in how the companies conduct their business. Ideally we would shed those implicit guarantees altogether, along with the very notion of too big to fail. But that is all but impossible now and for the foreseeable future. Even if the Obama Administration and Fed were to declare with one voice that banks such as Goldman were on their own, no one would believe it.

. . . Banks that want to be successful will also want to be more like Goldman Sachs, creating an incentive for both larger size and more risk-taking on the taxpayer’s dime.

One policy response to the incentives created by last fall’s bailout is simply to restrict the proprietary trading done by the subsidiaries of bank holding companies that enjoy both FDIC deposit insurance and an implicit government subsidy on their cost of capital. This is what Paul Volcker proposed, only to be overruled by Tim Geithner and Larry Summers. Another answer would be an FDIC-style bailout tax, perhaps tied to leverage ratios, for those in the too-big-to-fail camp. Developing a template to facilitate the seizure and orderly winding down of failing financial giants is also an essential element of whatever reform Congress cooks up.

Did I read that right? The WSJ proposing a new tax?

And here’s Carney’s conclusion:
What’s worse, letting CIT fail might not help this situation at all. Rather than clearing the way for market discipline to reassert itself, CIT’s failure might only reify the policy of Too Big To Fail. Financial firms that are deemed too small to be rescued will find credit hard to come by and expensive, which will incent them to grow or sell themselves to a systemically important firm. In short, we’re increasing the concentration of financial power and hence systemic risk in the largest Wall Street firms that led us into this mess.

To use traditional labels for a moment, the right-wing criticism is that the implicit government guarantees created by Too Big to Fail distort the market. The left-wing criticism is that bailing out large banks enriches capitalists at the expense of ordinary people, and the benefits don’t trickle down into the economy at large (see the number of foreclosures, for example).

The Obama Administration’s defense is that only by enriching those banks can we keep the economy from sinking further and hurting everybody. It’s not an implausible position to defend, but it can’t be fun, especially for people who always thought they were progressives.

*By James Kwak*
Is It Possible to Detect Bubbles?

James Kwak | 16 Jul 2009

On the one hand, it seems obvious; didn’t we all know there was a housing bubble back in 2006? On the other hand, if it’s that easy, why aren’t we all as rich as John Paulson?

A while back I suggested that the Fed could spot a housing bubble by treating housing prices the same way if treats the prices that make up the CPI. If there is high inflation in the core CPI, you don’t stop and ask if there is a fundamental reason for higher inflation; you tighten monetary policy (raise interest rates). The Fed could do the same thing for housing prices, since housing is an asset that people need to consume. But that’s probably a simplistic view.

Leigh Caldwell thinks that behavioral approaches may be able to separate out irrational overvaluation from changes in fundamental values. I believe his argument is that you can measure the degree of irrational overvaluation for certain types of assets, and you can extrapolate from there to see if there is a bubble:

Outside of the laboratory, precise knowledge of the returns of some assets does become available at times, and it would be possible to measure investors’ behaviour with regard to those assets. If investors, in aggregate, become overconfident about returns it will be possible to spot this from certain types of price change.

This makes logical sense to me, but it’s pretty vague. Caldwell’s VoxEU post goes a bit further:

I propose that regulators develop a small set of measures of irrationality that can be calculated and published at least monthly. These might include measures related to expected personal income, job security and asset values; measures of expectations about the performance of the economy as a whole; and measures of hyperbolic discount rates and other specific observable cognitive biases.

In essence, I think, the idea is that instead of trying to figure out whether a given financial asset is overvalued, we create an index of consumer expectations and cognitive biases and use that to tell us if we
are in a bubble. If people are wildly optimistic, as reflected both in what they say and in how they act, then asset prices are probably also irrationally high.

There may be something here, but I worry that you still have to have something to compare your expectations index to. We already have indexes of consumer confidence – which, granted, are not quite what Caldwell is talking about – and I don’t think they have been much good as bubble-spotting devices. Maybe if you graphed consumer confidence against average economic forecasters you might see something – but most likely those forecasters are just as prone to irrational exuberance as the ordinary person. Really what we want is a reliable indicator of irrational exuberance that will be the same in every bubble; but how you would find such a thing, and how you would be sure that it would work in the next bubble, is beyond me.

*By James Kwak*
The AEI Versus the Real World

James Kwak | 16 Jul 2009

Peter Wallison of the American Enterprise Institute accuses the Consumer Financial Protection Agency of being a liberal plot to restrict good financial products to sophisticated elites. Mike at Rortybomb does a point-by-point takedown complete with actual data, so I can stick to the high level (not to be confused with the high road).

Wallison’s op-ed reads like a caricature of conservative ideology – all supposed moral principle and no real-world implications. His argument is basically that by imposing restrictions on complex products (Option ARM mortgages) that are not imposed on plain vanilla products (30-year fixed-rate mortgages), the CFPA is limiting choice for the poor and unsophisticated and preserving choice for the rich and sophisticated; since according to conservative ideology choice is always good in principle, the CFPA is discriminatory.

Where do we start?

First, this is exactly the way consumer protection is supposed to work. If you go to a convenience store, or wherever you can still buy cigarettes, you can buy lots of things that don’t have warning labels. The cigarettes have warning labels.

Wallison dismisses warning labels with a non-argument: “If the issue is whether the consumer understood the risks of the more complex product, strong warning labels or written ‘opt-ins’ simply raise the same question and will not be a defense for the provider.” Warning labels and written opt-ins are used all over the economy; every time you sign a piece of paper saying that you understand the risks of something and you agree not to hold the provider liable, you are opting in. It is true that these do not always hold up in court, but that’s a fact-specific question. In general, they certainly do protect service providers, although Wallison asserts the contrary.

Second, this is exactly the way securities regulation works today. The Securities Act of 1933 creates exemptions for securities that are only sold to “sophisticated” investors. This is how hedge funds escape most regulation; they only allow sophisticated investors in. The CFPA is extending this principle to a class of financial instruments that, in 1933, no one thought could be complex enough to be limited to sophisticated investors.
Third, the CFPA is simply broadening the concept of fiduciary responsibility, which already exists for various categories of service providers, such as lawyers, CPAs, and some investment advisors. Someone with a fiduciary responsibility has to put the interests of his client first. In a financial context, this would mean that you can’t put a client into a financial product that does not serve his interests. The purpose of the CFPA is similar: you can’t sell a product to someone without first making sure he understands what you are selling him. Now, this is not exactly the same thing as a fiduciary responsibility; it’s actually considerably weaker. The point is that the idea that you should not treat your customers in ways that harm them is hardly liberal or elitist.

Fourth, Wallison asserts, without example or argument, that the more complex products are better.

So who will be able to get those more complex products and services? Not ordinary Americans, whose lack of financial sophistication will make the risks of selling to them too great for most providers. The more complex products, the ones that are better tailored to the needs of the particular consumer, will be offered only to the more sophisticated and better educated — in other words, to the nation’s elites.

“Better tailored to the needs of the particular consumer?” We’re talking about exploding mortgages and reverse convertibles here. Speaking as someone who could pass any test of sophistication, my personal opinion is that the CFPA regime would actually benefit the “unsophisticated,” because the “more complex products” are just higher-margin ways for banks to relieve rich people of their money. It’s a good thing that most people are not allowed to pay hedge funds 2-and-20 for the privilege of not being able to take their money out whenever they want. But that’s another topic.

Fifth, Wallison asserts that this is “not because the products or services are inherently dangerous, like drugs or explosives,” and hence need consumer protection. This completely ignores the biggest news story of the last two years (OK, maybe the second-biggest story after the election of an African-American president). We have millions of foreclosures — that’s people losing houses who either (a) would not be losing their houses if they had been given traditional mortgages that they would have qualified for or (b) would have been better off renting and not
losing down payments, closing costs, refinance costs, and their credit ratings. Those foreclosures have negative externalities for their neighborhoods, including lower property values and higher crime. (Mike already nailed this in his now-famous “degenerate crackhead” example in this post.) And we have the biggest recession since the 1930s. How are complex financial products not inherently dangerous?

Sixth, what’s the alternative? The only one that Wallison mentions is disclosure.

Traditionally, consumer protection in the United States has focused on disclosure. It has always been assumed that with adequate disclosure all consumers — of whatever level of sophistication — could make rational decisions about the products and services they are offered. No more. . . .

Apparently, adequate disclosure will not be the answer to the provider’s dilemma. As outlined in the white paper, no amount of disclosure can adequately protect consumers against complexity.

Note that Wallison is clever enough to avoid saying that disclosure works – because it obviously doesn’t. But still he leaves it floating out there as his only alternative to the CFPA. So let’s avoid the clever rhetoric. Disclosure doesn’t work. If it did, we wouldn’t be where we are today. We tried it; now we need to try something else. And Wallison doesn’t suggest anything.

What ties these six points together? Let’s see, we have:

1. ignoring the fact that warning labels and opt-ins are already used routinely in the economy;
2. ignoring the fact that the “sophisticated investor” concept is already used in the financial industry itself;
3. ignoring the fact that fiduciary duty, which is more restrictive than the CFPA approach, is already used for various classes of professionals;
4. ignoring the very real possibility that complex financial products are not actually good for you;
5. ignoring the fact that the financial products in question have just caused enormous harm to millions of people; and
6. ignoring the fact that his implied alternative, disclosure, has resoundingly failed.
The genius of the modern conservative movement (not the traditional conservatism of Edmund Burke, for which I have a great deal of respect) has been its understanding that to win in politics, the facts of the real world – the “judicious study of discernible reality,” if you will – only slow you down. Wallison does the movement proud.

By James Kwak
CIT Down

Simon Johnson | 16 Jul 2009

At the end of the day, CIT had nothing. Their asset quality was poor, their systemic risk implications seemed limited, Sheila Bair dug in her heels, and Jeffrey Peek (CEO) didn’t have sufficiently strong connections to get her overruled.

CIT had friends, but not enough - and maybe this tells us something about the shifting political sands. The Financial Services Roundtable (top financial CEOs) came out in force, the House Committee on Small Business reportedly made worried noises, and Barney Frank sounded supportive. But the American Bankers Association (the broader mass of bankers) publicly stood on the sidelines and Senate Banking – and prominent senators – seemed otherwise engaged.

CIT’s small and mid-size customers are important to the recovery. But the reckoning is that this business can be easily sold to someone else – after all, this is exactly what bankruptcy can get right in the U.S.

So the question became: is CIT too big – on its liabilities side – to fail? And if $80bn financial firms are now “too big to fail”, what does that imply for other potential bailout conversations and for our fiscal future?

In the final analysis, CIT wasn’t even big enough to meet Secretary Geithner face-to-face – he’s still out of the country.

The bottom line: we need fewer $800bn firms and more $80bn firms. If Goldman Sachs were broken into 10 independent pieces, we could all sleep much more soundly.

By Simon Johnson

(More in my NYT.com column this morning – what are the implications of CIT’s failure for overall levels of capital in the banking system? This will run shortly.)
Who Nationalized Whom?

Simon Johnson | 17 Jul 2009

Hank Paulson’s testimony yesterday was informative, if only because it illustrated that he himself still understands little about the origins and nature of the global crisis over which he presided. Perhaps his book, out this fall, will redeem his reputation.

A fundamental principle in any emerging market crisis is that not all of the oligarchs can be saved. There is an adding up constraint – the state cannot access enough resources to bail out all the big players.

The people who control the state can decide who is out of business and who stays in, but this is never an overnight decision written on a single piece of paper. Instead, there is a process – and a struggle by competing oligarchs – to influence, persuade, or in some way push the “policymakers” towards the view:

1. My private firm must be saved, for the good of the country.
2. It must remain private, otherwise this will prevent an economic recovery.
3. I should be allowed to acquire other assets, opportunities, or simply market share, as a way to speed recovery for the nation.

Who won this argument in the US and on what basis? And have the winners perhaps done a bit too well – thinking just about their own political futures?

On who must be saved, we see the new dividing line. If you have more than $500bn in total assets, post-Lehman, you make the first cut. If you’re below $100bn (e.g., CIT), you can go bankrupt.

On remaining private, the outcome is more complicated. Citigroup had the best political connections in the business, but turned out to be so poorly managed that the state essentially had to take over – in a complicated and ultimately unsatisfactory way. Bank of America’s relatively weak political connections meant that the impulse purchase of Merrill Lynch could go very badly – and also led to a bizarre form of government takeover.

The prevailing idea and organizing principle for this new sorting is not Lloyd Blankfein’s “we’re the catalyst of risk” – investment banks are peripheral, rather than central, to nonfinancial risk taking and investment in this country. It’s Jamie Dimon’s idea: just don’t demonize
the competent bankers, let us take things over and we’ll smooth it all out.

The problem with this approach is its “success”, from the point of view of the remaining bankers – their market share is up so sharply that it’s embarassing. Of course, they can still argue that banking is a global industry with many competitors (some of which are even bigger, with more state assistance, promising much craziness in the years ahead).

But the real issue now is concentration in the political marketplace. Hank Paulson dealt with a dozen big banks/similar institutions with deep connections to Capitol Hill and a very powerful small banking lobby. Tim Geithner is looking at just a couple of big banks that are still independent. Probably we should start to divide our big banks into the “nationalized” and the “nationalizers”.

The small banks still have clout – and you’ll see them in force on the regulatory reforms debate this fall – but they know now that they don’t get bailouts, and access to contingent state capital-on-amazing-terms is the ironic basis of modern financial power.

We are looking at a concentration of political power in the US banking system that we haven’t seen since the 1830s: Shades of Andrew Jackson vs. the Second Bank of the United States. We put up with a lot from our banking elite in this country, but historically we draw the line at financial power so concentrated it can confront the power of the President.

The logic for reform and for breaking up the big banks begins to build. Bank of America’s fall was, in some senses, a fortunate accident for Goldman and JP Morgan. But it has also given them an excessive and unsustainable degree of political power.

Of course, you also have to ask: Who can break that power, when, and how?

By Simon Johnson
More on Spotting Bubbles

James Kwak | 17 Jul 2009

In comments on my previous post on bubbles, John McGowan and others point out that you can use the price-to-rent ratio (or price-to-income) as an indicator of a housing bubble. I think this is a partial but not a perfect solution.

The value of a thing should be the net present value of the future cash flows from the thing. In experimental economics, they use securities with absolutely certain cash flow profiles, so when a bubble in prices appears, you have an objective measure of value to compare it to. With individual stocks, on the other hand, the P/E ratio could go up to 100, and you can back an implied growth rate of earnings out of that, but who’s to say the company won’t hit that growth rate? At that point it’s just your opinion against the market’s.

The question is whether housing is like an economics experiment or like stocks. I think it’s pretty clear that one house is more like an individual stock. You could look around at other houses you might rent, but houses tend to be somewhat unique. (This is also one reason why bubbles perpetuate themselves; as Bond Girl pointed out, people are perfectly able to believe that one part of the market is in a housing bubble, but the part they are buying in is not in a bubble.)

Now, as Leigh Caldwell pointed out, it should be easier to spot a bubble when looking at all stocks in aggregate. If the implied growth rate of earnings of the entire market is 20%, then that looks implausible. Similarly, if the price of houses in aggregate is twice the value implied by the rental income they could generate, that looks implausible.

I say this approach is partial but not perfect because current potential rental income is a poor proxy for the long-term value of a house. The fact is that most people buying houses aren’t going to be renting them out, and what they care about is the price at which they will be able to sell that house in 10 years, which depends in part on the price at which that buyer will be able to sell the house 10 years after that, and so on. And it’s entirely possible that the relationship between house prices and rents could change over that timeframe due to any number of economic factors – the homeownership ratio; shifts between the exurbs, suburbs, and cities; the aging of the population; and so on. There’s no axiom that says that these ratios – price-to-rent or price-to-income or price-to-earnings for that matter – have to remain constant over the long term. At
the least, it’s generally possible to come up with a reasonable argument that things have changed *this time*. In part, that’s why we have bubbles, but it’s also why it’s hard to be objectively sure you’re in one.

*By James Kwak*
Jamie Dimon v. Larry Summers

Simon Johnson | 19 Jul 2009

Jamie Dimon has won big. JP Morgan Chase now stands alone, both in financial position and political clout – including special access to the White House and, as explained in today’s NYT, Rahm Emanuel’s likely attendance at his next board meeting tomorrow.

Dimon’s semiotics have been brilliant throughout the crisis – it wasn’t his fault, he was forced to take TARP money, and – in phrasing that will make the history books – bankers should not be “vilified”. But now he has a problem.

Larry Summers forcefully stated Friday that high recent profit levels for big banks (i.e., JPMorgan and Goldman) are based on the support they received and still receive from the government (listen to his answer to the second question, from about the 6:10 to 10:30 mark). At that level of generality, in a period of financial stabilization and consequent reduction in executive branch discretion, this statement does not threaten Dimon or anyone else.

And Summers’ statement on the dangers of “too big to fail” was “too vague to succeed”. Dimon saw this one coming and is very much aligned with Tim Geithner on the technocratic fixes that will supposedly take care of this – the mythical “resolution authority”, which will not actually achieve anything because it has no cross-border component, so the next time a major multinational bank (e.g., JP Morgan) fails, the choice again will be “collapse or bailout” (as Summers put it in the same Q&A Friday). Yes, I know the G20 is supposedly working on this; no, I don’t think they are making progress.

But Summers also drew a line in the sand on consumer protection.

Reformists within the administration really need a new consumer protection agency for financial products – there is little else they will be able to point to as an achievement on banking issues. Summers did not, for example, on Friday even mention the need for stronger regulation over derivatives; Dimon has likely already prevailed on this.

Consumer protection is easy for people to understand. If the banking lobby really defeats or defangs it this year – as it almost certainly can – won’t that make meaningful re-regulation of banking a big issue for the midterm elections in 2010 and beyond?
And does Dimon really want to publicly confront and defeat Larry Summers?

It must be tempting for Dimon to now press home his advantage, including at the White House. But as JP Morgan Chase stands alone at the top of our banking hierarchy, how far should he push his luck?

Summers has an unparalleled ability to move the consensus. And if he is now running from the left to become chair of the Fed – which was my impression on Friday – this will shift all candidates, including Ben Bernanke, towards being tougher on banks.

Why doesn’t Dimon instead seize on greater consumer protection as a way to rebuild legitimacy for finance – and to shape the new rules so as to create barriers to entry and growth for future rivals?

What would John Pierpont Morgan have done?

By Simon Johnson
The Rise and Rise of Jamie Dimon

James Kwak | 19 Jul 2009

As Simon pointed out earlier, Jamie Dimon has been getting a lot of good press recently. The New York Times portrayed his recent rise to prominence as not only the CEO of American’s number one bank (at least, the number one bank that has not recently been compared to a vampire squid), but as a player in Washington and, according to at least one quip, the man Barack Obama turns to on financial questions:

Now that Mr. Obama is in the White House, Mr. Dimon has been prominent when the president wants to talk to big business.

During one such meeting in late March, as Citigroup’s chairman, Richard D. Parsons, was trying to explain banks and lending, the president interrupted with a quip: “All right, I’ll talk to Jamie.”

I also just read Fool’s Gold, Gillian Tett’s book about (a) the expansion of the credit derivatives market by J.P. Morgan in the 1990s (fascinating) and (b) the financial meltdown of 2007-2008 (familiar). Tett paints a picture of Dimon as a super-competent, details-oriented, finance-savvy CEO who reshaped JPMorgan Chase during the boom and positioned it to emerge from the crisis stronger than any of its commercial banking rivals.

The issue at the center of the Times article is what changes the government will seek in the financial system, and what the major banks are doing to oppose or weaken those changes. Dimon and his colleagues are well within their rights to call their administration contacts and flex their PR muscles to lobby for less regulation as the political climate shifts more and more in their favor (because public fear for the banking system and anger at bankers is clearly receding). As Simon pointed out, it may actually be to his advantage to play along with some of the administration’s proposals, for both political and competitive reasons.

The broader policy question – which may be more a historical question by this point – is why the administration’s would-be reformers even have to fight this battle. Fool’s Gold, or any account of the onset of the panic in September 2008, serves as a reminder of what the world was like then:
Merrill Lynch, Goldman Sachs, and Morgan Stanley suddenly found it impossible to raise funds in the capital markets. So did a host of European banks in Ireland, the UK, Holland, and elsewhere. The implication was brutal: across the Western world, the senior managers of a host of the world’s largest banks and brokers quietly told their central banks that they could collapse within days.

That these banks even exist today is solely the result of government intervention. Like Paul Krugman, I think some form of intervention was warranted, because of the huge potential costs – to everyone – of a failure of the banking system. But like Krugman, I also think the government should have acted sooner and more forcefully to ensure that the new benefits handed to banks – most notably a much-strengthened implicit government guarantee – were balanced by new regulatory powers.

What’s clear is that Wall Street in general, Goldman very much included, benefited hugely from the government’s provision of a financial backstop — an assurance that it will rescue major financial players whenever things go wrong.

You can argue that such rescues are necessary if we’re to avoid a replay of the Great Depression. In fact, I agree. But the result is that the financial system’s liabilities are now backed by an implicit government guarantee.

Now the last time there was a comparable expansion of the financial safety net, the creation of federal deposit insurance in the 1930s, it was accompanied by much tighter regulation, to ensure that banks didn’t abuse their privileges. This time, new regulations are still in the drawing-board stage — and the finance lobby is already fighting against even the most basic protections for consumers.

Jamie Dimon may be a great CEO. But that we have to count on his magnanimity to not torpedo the Consumer Financial Protection Agency is a bit much.

By James Kwak
More and Better

James Kwak  |  20 Jul 2009

After the wholesale discrediting of the strong form of the efficient markets hypothesis, Robert Shiller may be the most respected financial economist in the world at the moment. This is what he has to say on the last page of Justin Fox’s *The Myth of the Rational Market*:

Finance is a huge net positive for the economy. The countries that have better-developed financial markets really do better. . . . I think that we’re less than halfway through the development of financial markets. Maybe there’s no end to it.

I think Shiller’s first and second sentences are almost certainly true. There is a strong correlation between having a high material standard of living and having a relatively sophisticated financial system; think of the United States, Japan, and Germany as opposed to Zimbabwe, for example. But you can’t infer that more financial market “development” is always better. (I’m not saying that Shiller necessarily believes that, but most of the defenders of financial innovation take it for granted.)

Just because something is good, it doesn’t necessarily follow that more of it is better. Take food, for example. It’s pretty obvious that over a wide range – say from 0 to 1500 calories per day – more food is better for you. For most people that range probably extends up to 2000 calories or a little more. After that, not so much.

I and others have made this point about financial innovation. You could make a similar argument about health care technology. To a point, using more technology – scans, implants, drugs, etc. – does correlate with better outcomes. Beyond that point, if the technology is being used instead of preventative medicine and old-fashioned doctoring, it doesn’t provide much incremental value, and may actually hurt. (If, in addition, the high use of technology is pushing up the cost of health care and making it unaffordable for millions of people, then it may really hurt.) Really all we’re talking about is the fact that marginal returns tend to diminish, and they can diminish to zero.

I’m not saying that we should put a lid on financial (or medical) innovation once and for all. As the economy changes over the next decades and centuries, the financial system we need will change as well.
But this fallacy that more of a good thing must always be better is so simple and so deep-seated that it’s worth being aware of it.

By James Kwak
What Is the Efficient Market Hypothesis?

James Kwak | 20 Jul 2009

Brad DeLong cites Underbelly citing The Economist quoting Richard Thaler:

The [Efficient Capital Markets] hypothesis has two parts, he says: the “no-free-lunch part and the price-is-right part, and if anything the first part has been strengthened as we have learned that some investment strategies are riskier than they look and it really is difficult to beat the market.” The idea that the market price is the right price, however, has been badly dented.

I think this is exactly right. Ever since graduate school I have said that I believe in efficient markets, by which I mean the “no-free-lunch part.” The idea that some people might think that “no free lunch” implied that “prices are right” didn’t even occur to me at the time. My thinking was basically like this: yes there are bubbles, but it’s hard to tell if you are in one, and even if you can tell, you can’t tell how long it will last so you can lose a lot of money betting against it, and even if you have a very long time horizon, who’s to say you won’t be in another bubble when you finally want to sell? Put another way, you may be “right” about an asset price, but if the market is composed of lots and lots of people who are “wrong,” and those people are never going away, what does that get you?

More fundamentally, for an interesting asset like a share of stock (or a house), what does it even mean for a price to be “right?” Sure, ten years later you can see what the dividends have been for ten years and what the stock price is on that date, but that price is no more “right” than any other price; it’s still a collective, irrationality-tainted guess about the future. Future states of the world are not only unknowable right now, they don’t exist right now, so questions of right and wrong don’t even apply to them. There are just better and worse estimates, and there will never be any way to determine which estimate was better. (Just because things work out a certain way doesn’t imply that that was the most likely outcome.)

I think I’ve beaten this question into the ground recently, so I’ll stop there.

By James Kwak
CEO Psychology

James Kwak  |  20 Jul 2009

If you need more reasons to dislike former Bear Stearns CEO Jimmy Cayne, apparently William Cohan’s new book about the fall of Bear gives you plenty more. I’m just judging from the excerpts in Malcolm Gladwell’s new article in The New Yorker, which is really about the tendency toward overconfidence among the people who rise to the top on Wall Street, but also quotes Cayne saying that people he doesn’t like are gay – and he doesn’t mean it in a nice way.

Gladwell tries to position psychology as an alternate explanation of the financial crisis:

Since the beginning of the financial crisis, there have been two principal explanations for why so many banks made such disastrous decisions. The first is structural. Regulators did not regulate. Institutions failed to function as they should. Rules and guidelines were either inadequate or ignored. The second explanation is that Wall Street was incompetent, that the traders and investors didn’t know enough, that they made extravagant bets without understanding the consequences. But the first wave of postmortems on the crash suggests a third possibility: that the roots of Wall Street’s crisis were not structural or cognitive so much as they were psychological.

I think this is a bit much. The fact that some Wall Street actors were megalomaniacs does not change the facts that regulators did not regulate, or that rules and guidelines were inadequate. Nor is overconfidence inconsistent with incompetence.

But Gladwell is probably right that overconfidence was a factor in the terrible decisions made by so many people. The problem, Gladwell argues, is that overconfidence is a useful trait to have in many settings – perhaps even an evolutionary adaptation. But then we fall into the trap:

“I’m good at that. I must be good at this, too,” we tell ourselves, forgetting that in wars and on Wall Street there is no such thing as absolute expertise.

In addition, the business world tends to breed overconfidence in CEOs. There is dumb luck in everything. But people who are successful
tend to think that their success is a product of their own abilities, which leads them to overestimate those abilities. The sycophantic nature of the corporate culture at most large companies only reinforces this delusion. Then there is the insistence by the media, analysts, and institutional investors that CEOs project constant, Herculean confidence. If a CEO were to say the truth on an earnings call – “I’m pretty happy about how we did last quarter; we got lucky and closed a couple of big deals we might not have won; if things go well next quarter we’ll meet our targets, but any number of things could go wrong” – investors would fall over themselves trying to dump his or her stock.

But all of these problems are endemic to modern American capitalism, not just Wall Street banks (although Wall Street trading floors are particularly fertile breeding grounds for overconfidence, given the nature of trading gains and losses, and the amount of money being made). I would tend to put it more in the category of problems that will always be with us than the category of specific causes of the financial crisis. Maybe the specific problem here was that megalomaniacs ascended to be head of systemically important banks that could bring down the entire financial system, rather than running airlines, telecom companies, private equity firms, high-tech companies, baseball teams, or other organizations whose collapse would not have such dire consequences.

*By James Kwak*
Three Myths about the Consumer Financial Product Agency

Simon Johnson  | 21 Jul 2009

This guest post was contributed by Elizabeth Warren, chair of the Congressional Oversight Panel and the Leo Gottlieb Professor of Law at Harvard University. (Update: more on the case for a CFPA in her YouTube video, released yesterday.)

I’ve written a lot about the creation of a new Consumer Protection Financial Agency (CFPA), starting with an article I wrote in the Democracy Journal in the summer of 2007. My writing has helped me work through the idea and has advanced a conversation about what kind of changes in financial products would be most effective. A couple of weeks ago, I testified before the House Financial Services Committee about why I think a new consumer agency is so important, and I’ve argued the case many times.

Today, though, I’d like to post specifically about some of the push back that has developed on this issue. In particular, I’d like to focus on three big myths – myths designed to protect the same status quo that triggered the economic crisis.

MYTH #1: CFPA Will Limit Consumer Choice and Hinder Innovation

At a recent hearing on the CFPA, Rep. Brad Miller challenged an industry representative to identify one consumer who chose double-cycle billing to be included within the terms and conditions of his or her credit card contract. It was a great moment. If the status quo is about choice, then explain why half of those with subprime mortgages chose high-risk, high-cost loans when they qualified for prime mortgages. If the status quo is about choice, then explain why Citibank declared itself consumer friendly, dropped universal default, then quietly picked it up again the following year because they said consumers couldn’t tell whether they had the term or not.

The truth, of course, is that no consumer “chooses” to accept the tricks and traps buried within the legalese of financial products. Rather, consumers must choose among various products with one feature in common: dozens of pages of incomprehensible fine print.

The CFPA will not limit consumer choice. Instead, it will focus on putting consumers in a position to make choices for themselves by streamlining regulations, making disclosures smarter, and making financial products easier to understand and compare. The Agency will promote plain vanilla contracts—short, easy to read mortgages and
credit card agreements. The key principle behind the new agency is that disclosure that runs on for pages is not real disclosure—it’s just a way to hide more tricks. Real disclosure means that a lender has to be able to explain what it is selling so that the customer can read it and understand it. Once consumers can understand the risk and costs of various products – and can compare those products quickly and cheaply – the market will innovate around their preferences.

Daniel Carpenter, a Professor of Government at Harvard University, has written a great deal about the modern pharmaceutical industry. While anyone with a bathtub and some chemicals could be a drug manufacturer a century ago, Carpenter points out that drug companies were willing to invest far more in research and development to bring good drugs to the market once FDA regulations drove out bad drugs and useless drugs. Good regulations support product innovation.

**MYTH #2: The CFPA Will Add Another Layer of Regulation and Increase Regulatory Burden**

Current regulations in the consumer financial area are layered on like pancakes—see a problem and fry up a regulation, but don’t integrate it with the earlier regulation. Today, seven different federal agencies have some form of regulations dealing with consumer credit. The result is a complicated, fragmented, expensive, and ineffective system. With consolidated and coherent authority, the CFPA can harmonize and streamline the regulatory system—while making it more effective.

But the real regulatory break-through for the CFPA would be the promotion of “plain vanilla” contracts that would likely meet the needs of about 95% of consumers. These contracts would have a regulatory safe harbor. By using an off-the-shelf template for a plain vanilla contracts and filling in the blanks for interest rates, penalty rates and a few other key terms, a financial institution can legally satisfy all its federal regulatory requirements—no need to do more.

Of course, some banks would want to offer more complicated products. For many, they could file-and-use, so long as they met the same regulatory standards of adequately disclosing risks and explaining costs—briefly enough and clearly enough for people to understand them.

A streamlined new regulatory regime would have a serious impact on the credit industry. Today’s complicated disclosure system favors big lenders that can hire a legion of lawyers to navigate the rules—and spread the costs among millions of customers. Those complex rules fall
much harder on a smaller institution that must navigate the same regulatory twists and turns, but with far smaller administrative staffs. Plain vanilla contracts will be particularly beneficial for community banks and credit unions that will be able to divert fewer resources toward regulatory compliance and more toward customer service and innovation.

**MYTH #3: Prudential and Consumer Regulation Cannot Be Separated**

Make no mistake: This is a fancy claim for the status quo. If the CFPA can be left with the current bank regulators, then it can be smothered in the crib. For decades, the Federal Reserve and the bank regulators (the OCC and the OTS) have had the legal authority to protect consumers. They have brought us to this crisis by consistently refusing to exercise that authority.

The agencies’ well-documented failures – discussed in detail by Travis Plunkett and Ed Mierzwinski [here](#) and by Professor Patricia McCoy [here](#) – are largely the result of two structural flaws. The first is that financial institutions can now choose their own regulators. By changing from a bank charter to a thrift charter, for example, a financial institution can change from one regulator to another. The regulators’ budget comes in large part from the institutions they regulate. If a big financial institution leaves one regulator, the agency will face a budget shortfall and the agency will likely shrink. Knowing this, financial institutions can shop around for the regulator that provides the most lax oversight, and regulators can compete by offering to regulate less. Regulatory arbitrage triggered a race to the bottom among prudential regulators and blocked any hope of real consumer protection.

The second structural reason that prudential regulators failed to exercise their authority to protect consumers is a cultural one: consumer protection staff at existing agencies find themselves at the bottom of the pecking order because these agencies are designed to focus on other matters. At the Federal Reserve, senior officers and staff wake up every morning thinking about monetary policy. At the OCC and OTS, agency heads wake up thinking about capital adequacy requirements and safety and soundness. Consumer protection issues are—at best—an afterthought. The CFPA would create a home in Washington for people who wake up each morning thinking about whether American families are playing on a level field when they buy financial products. By bringing economic experts who care about consumer financial issues
under one roof, CFPA can develop as a smart agency that develops real expertise.

A single consumer agency would also be able to make sure that the same products face the same regulations. Today, mortgages are regulated differently depending on whether they are issued by a bank, a nationally-chartered thrift, a nationally-chartered credit union, and so on. Imagine for a moment if toasters or toys had different safety standards depending on who manufactured them. Or, even worse, imagine if some manufacturers could bypass safety standards almost in entirety – as is now the case for non-depository financial institutions. It is time for one Agency to regulate financial products in a consistent manner across the board.

In 2001, Canada created an independent agency much like the proposed CFPA. I recently spoke with some Canadian economists, and they not only said the system works, they also expressed bewilderment about the idea that prudential and consumer regulation would be combined. As one said, they “have different ways of thinking about the world.”

At the end of the day, industry lobbyists try hard to invent myths and make things sound confusing to intimidate the public and to keep policymakers from acting. But this issue is simple: keeping safety and soundness and consumer protection together has not ensured safety and soundness, has not protected consumers, has not fostered choice and innovation, and has not minimized regulatory burden. In fact, the current regulatory structure that combines consumer protection with other bank oversight responsibilities has led to the kind of bad regulatory oversight that has led us to this crisis. The CFPA would put someone in Washington—someone with real power—who cares about customers. That’s good for families, good for market competition, and good for our economy.

**Update:** Fixed link to Democracy article in first paragraph. Thanks to Uncle Billy vs. Mont Pelerin.

*By Elizabeth Warren*
The Problem with Federalism

James Kwak  | 22 Jul 2009

Paul Krugman and many others have been talking about the “fifty little Hoovers” – state governments forced by balanced-budget rules to cut spending and raise taxes in the face of a recession, eliminating services when they are most needed and deepening the economic downturn. James Surowiecki (hat tip Matthew Yglesias) expands the attack by arguing that federalism (the idea that power is balanced between the national and state governments) in general is a problem, at least in these economic circumstances. In addition to counter-cyclical state fiscal policy, he cites political issues such as the disproportionate allocation of road spending to areas with few people and coordination problems such as the difficulty building national transportation or energy networks.

It may seem as if the balance is tilted heavily in favor of the national government – it has an army, it prints money, and so on – but the Constitution leans more toward protecting state autonomy (see the principle that the federal government is one of enumerated powers, and the Tenth Amendment), and the trend of the Reagan Revolution and the Rehnquist Court was to favor states’ rights. (Of course, “states’ rights” are not necessarily a Republican or a Democratic issue, but tend to be favored by whichever side finds the argument convenient at the moment.)

When I was young (like in high school) I thought states were silly and we should just have a national government, like in France, where the departments are mainly just administrative units. When I got a little older and became a qualified fan of Edmund Burke, I decided that the current system worked well enough most of the time that it would have to be seriously broken to justify a major structural change.

I’m not sure it qualifies as seriously broken at the moment, but I think the current recession counts as evidence that it sure isn’t the system you would design if you were starting from scratch.

By James Kwak
Much Ado About Bernanke

James Kwak  | 22 Jul 2009

There has been a lot of talk recently about Ben Bernanke, he of the Wall Street Journal op-ed and the multiple Congressional appearances. (Hey, can anyone put me in touch with his agent?*) At the risk of seeming ignorant (or revealing myself to be ignorant), I must say I don’t really understand what the fuss is about.

The question seems to be whether the Fed will be able to tighten monetary policy fast enough when necessary to dampen the potential inflationary effect of its current expansive monetary policy (Fed funds rate at zero, buying long-term securities, etc.). My read on the situation is as follows:

1. Almost everyone agrees that expansive monetary policy has been appropriate during the crisis and recession to date.
2. Everyone agrees that at some point monetary policy will have to be tightened.
3. No one knows when that will happen.
4. Everyone agrees that because policy has been so expansionary recently, tightening monetary policy when necessary will be more difficult than usual.
5. Everyone agrees more or less on what tools will be available to the Fed.
6. No one is certain the Fed will or will not be successful, because there are no relevant datapoints to compare it to.
7. No matter what Bernanke actually thought, he would still have to say exactly what he is saying this week.

I don’t see much in there worth arguing about.

As Catherine Rampell says, a more interesting question is when the Fed will start tightening policy. This is the kind of thing that can set the Fed against the administration, as stereotypically one focuses on inflation and the other on unemployment. But since most people think it is too early to start now, that debate would be purely speculative at the moment.

* He does need a grammar checker, though. His first sentence – “The depth and breadth of the global recession has required a highly accommodative monetary policy” – contains an error in subject-verb agreement.

By James Kwak
What Are You (Or Barney Frank) Going To Do About It?

Simon Johnson  |  22 Jul 2009

At a hearing of the House Financial Services Committee yesterday, Barney Frank nicely summarized where we are with regard to re-regulation of our largest financial institutions: some of them are definitely “too big to fail”, with the potential to present the authorities with what Larry Summers calls the “collapse or bailout” choice, but what exactly should be done about it?

On a five-person panel, I had the middle seat (as usual) and found myself agreeing with points made both to my left and to my right. Alice Rivlin is correct that we need to control leverage as well as increase capital requirements, and the Fed’s tools vis-à-vis leverage need modernization – your grandparents’ margin requirements would not suffice. Peter Wallison, a member of the new financial crisis investigation commission, stresses that capital requirements should be higher for larger banks. Paul Mahoney wants to change the bankruptcy code, to make it easier for courts to handle large financial firms in quick time; recent CIT Group events suggest this is a good idea.

And Mark Zandi was persuasive on the point that households had no idea what they were signing up to with option ARMs – even he has trouble with those spreadsheets. Effective consumer protection – including a new consumer safety commission – would definitely contribute to financial system stability.

What will Barney Frank and his committee do? There will be no “Tier 1 Holding Company” category of firms, if Frank has anything to do with it; this is too much like creating an implicit government guarantee. Frank is clearly drawn towards higher capital requirements or more insurance payments from firms that pose more system risk. I suggested total assets of 1% of GDP as a threshold, but we agree this should be essentially a progressive drag on profits – creating the strong market-based incentive for the biggest firms to downsize.

Other than that, watch this space.

My written testimony submitted to the committee is below.

Main Points

1) The U.S. economic system has evolved relatively effective ways of handling the insolvency of nonfinancial firms (through bankruptcy) and small or medium-sized financial institutions with retail deposits
(through a FDIC-run intervention process). These kinds of corporate failures inflict limited costs on the real economy, and even a string of problems in such firms does not generally jeopardize the entire financial system.

2) We do not yet have a similarly effective way to deal with the insolvency of large financial institutions (e.g., any bank with assets over $500bn, which is roughly 3 percent of GDP). When one of these firms gets into trouble, the authorities face an unpalatable choice of “bailout or collapse.” If the problems spread to more than one firm, the balance of responsible official thinking shifts towards: “bailout, at any cost”.

3) The collapse of a single large bank, insurance company, or other financial intermediary can have serious negative consequences for the U.S. economy. Even worse, it can trigger further bank failures both within the United States and in other countries – and failures elsewhere in the world can quickly create further problems that impact our financial system and those of our major trading partners.

4) As a result, we currently face a high degree of systemic risk, both within the United States and across the global financial system. This risk is high in historical terms for the US, higher than experienced in most countries previously, and probably unprecedented in its global dimensions.

5) Short-term measures taken by the US government since fall 2008 (and particularly under the Obama administration) have helped stabilize financial markets – primarily by providing unprecedented levels of direct and indirect support to large banks. But these same measures have not removed the longer-run causes of systemic instability. In fact, as a result of supporting leading institutions on terms that are generous to top bank executives (few have been fired or faced other adverse consequences), systemic risk has likely been exacerbated.

6) Some of our largest financial firms have actually become bigger relative to the system and stronger politically as a result of the crisis. Executives of the surviving large firms have every reason to believe they are “too big to fail.” They have no incentive to help bring system risk down to acceptable levels.

7) Specifically, the surviving large U.S. financial firms and their foreign competitors have a strong incentive to resume “pay-for-performance” incentive systems – they compete by attracting “talent,” and if any one firm brings its compensation under control, it will lose skilled employees. But these firms – and their regulators – have also
demonstrated they cannot prevent such incentives from becoming “pay-for-disguised-risk-taking” on a massive scale.

8) The potential for unacceptable systemic risk remains deeply engrained in the culture and organizational structure of Big Finance. Over the past 30 years, this sector has benefited from a process of “cultural capture,” through which regulators, politicians, and independent analysts became convinced this sector had great and stabilizing technical expertise. This belief system is increasingly disputed, but still remains substantially in place – big banks are, amazingly, still presumed by officials to have the expertise necessary to manage their own risks, to prevent system failure, and to guide public policy.

9) There are four potential ways to reduce system risk going forward

1. Change our regulations so as to reduce ex ante risk-taking, e.g., by more effectively controlling the extent of leverage in the financial system or by more tightly regulating derivatives transactions.
2. Change the allocation of regulatory authority within the financial system, so that the relative powers of the Federal Reserve, Treasury, FDIC and various other regulators are adjusted.
3. Make it easier for the authorities to close down failing large financial companies using a revised “resolution authority.”
4. Change the size structure of the financial system, so that there are no financial institutions that are “too big to fail”.

10) All of these approaches have some appeal and it makes sense to proceed on a broad front – because it is hard to know what will gain more traction in practice.

11) The growing complexity of global financial markets means that even sophisticated financial sector executives do not necessarily understand the full nature of the risks they are taking on.

12) There is no ideal – or even proven – regulatory structure that will work inside the U.S. political system. Relative to the alternatives, strengthening the FDIC makes sense. For certain levels of potential bailout (e.g., as with CIT Group recently), the FDIC has an effective veto power over providing some forms of government support. This has proved a helpful check on the discretion of the Federal Reserve and the Treasury recently, but it would be a mistake to assume this will be the case indefinitely.

13) While an extended “resolution authority” could be helpful, it is not a panacea. As markets evolve, new forms of interconnections evolve –
and we have learned that not even managers of the best run banks understand how that affects the transmission of shocks. Furthermore, as banks become more global, an effective resolution authority would need to span all major countries in comprehensive detail. We are many years away from such an arrangement.

14) The stakes are very high – the country’s fiscal position has been significantly worsened by the current crisis, and our debt/GDP ratio is on track to roughly double.

15) As a result, it makes sense also to consider measures that will reduce the size of the largest financial institutions. The recent experience of CIT Group suggests that a total asset size under $100bn may provide a rough threshold, at least on an interim basis, below which the government can allow bankruptcy and/or renegotiation with private creditors to proceed.

16) Market-based pressure for size reduction can come through a variety of measures, including higher payments to the FDIC (or equivalent government insurance agency) from institutions that pose greater system risk, higher capital requirements for bigger firms, and differential caps on compensation based on the cost of implied government assistance in the event of a failure – think of this as pre-payment for failure.

17) Breaking up our largest banks is entirely plausible in economic terms. This action would affect less than a dozen entities, could be spread out over a number of years, and would likely increase (rather than reduce) the availability of low-cost financial intermediation services.

18) The political battle to set in place such anti-size measures would be epic. But as in previous financial reform episodes in the United States (e.g., under Teddy Roosevelt at the start of the 20th century or under FDR during the 1930s), over a 3-5 year period even the most powerful financial interests can be brought under control.

19) If we are able to make our largest financial firms smaller, there will still be potential concerns about connected failures or domino effects. Much tougher implementation of “safety and soundness” regulation is the only way to deal with this. In that context, stronger consumer protection – through a new agency focused on the safety of financial products – would definitely help (as well as being a good thing for its own sake).
The remainder of this testimony (see this pdf) provides further background regarding how systemic risk developed to its current high levels in the U.S., and suggests why we need new limits on financial institutions whose management regards them as “too big to fail”.

S&P Revises Expectations for the Economy Downward

James Kwak  | 23 Jul 2009

Calculated Risk reports that S&P is increasing its forecasts for losses on subprime mortgages again. As I’ve said before, in principle this means that their expectations about the economy are worse today than they were yesterday. They’re not just saying that defaults will go up; they’re saying that they will go up by more than they thought before today.

I previously discussed why I think this is weird, and there are a number of good comments to that earlier post. My theory that they are trying to spread out the deterioration of their forecasts over several months to save face got some support. q and others explained that rating agencies lag the economy because they base their forecasts on published economic data. That may be true, and it may be the best explanation for what is going on, but if so it seems like a condemnation of the rating agencies, since their job is to estimate the likelihood of default, and one of the inputs to their models should be the economic situation. (Or maybe their job is to estimate default likelihood assuming “normal” economic conditions, and it’s up to the investor to adjust accordingly.)

Note that these are their macroeconomic forecasts, not revisions to ratings of specific bonds, so the bond-rating schedule isn’t the driving factor here.

By James Kwak
What Will Change?

James Kwak | 23 Jul 2009

Timothy Garton Ash is a prominent modern European historian, who became famous writing about the collapse of Communism and the transformation of Eastern Europe in the 1990s. It was something many people thought they would never live to see.

A friend asked me what I thought of Ash’s article a couple of months ago in The Guardian, where he asked what will come of modern capitalism in the wake of the financial and economic crisis.

An extreme “neoliberal” version of the free-market economy, characterised not just by far-reaching deregulation and privatisation but also by a Gordon Gekko greed-is-good ethos – and fully realised in practice only in some areas of Anglo-Saxon and post-communist economies – seems likely to find itself [left in ruins or at least very substantially transformed]. But how about a modernised, reformed version of what postwar German thinkers called the “social market economy”?

Ash goes even farther than what you might call the Continental European social-democratic model, and envisions a world with a better balance between production and consumption, between national and international governance, and between exploitation and protection of the environment.

Ash’s essay reflects the feeling that the financial crisis was so cataclysmic, and the behavior that precipitated it so indefensible, that it could not help but trigger a major change in economic organization and perhaps even in societal values. Today, it’s pretty easy to label it as hopelessly optimistic. Many emerging markets, with China in the lead, are determined to return to an economic boom as quickly as possible. In the United States, the official administration strategy is to reflate the banking system as a means of stimulating the economy. After a couple of months of uncertainty, the media has consolidated around reporting this as an ordinary recession, though more severe than most.

More fundamentally, people change only a little bit, and only very slowly. People may be a little less willing to buy flat-screen TVs on credit, but they will still aspire to own flat-screen TVs. Domestic political systems will still undercut attempts at international governance;
“internationalism” is perhaps more a dirty word than ever in the United States, as evidenced by the shameful attempts to portray Harold Koh (until recently dean of the Yale Law School) as un-American during his confirmation hearings. As for the environment, I have yet to see compelling evidence that the human race will pull it together in time to meaningfully slow down global warming, and if anything the recession is being used as an argument against investing in alternative energy.

In the longer term, I think we can hope for a few silver linings from this crisis and recession. People may be less willing to take on debt, which will mean greater domestic savings and therefore greater domestic investment with less foreign debt. People may feel less secure economically, or maybe will at least remember feeling less secure during the dark days of 2008-2009, which may make them a little more concerned about the poor and a little more willing to pay for a better social safety net. Graduates of our top universities may want to do something other than become bankers and hedge fund managers, and may invent new technologies and teaching methods instead of new derivatives. Maybe the glorification of extreme wealth will be tempered a bit for a few decades, so the ultra-wealthy will flaunt it a little less and the rest of us will admire it a little less.

All of these things would be good, and they may still happen. But it will be within a capitalist system that remains pretty much the same as before – perhaps with a tiny bit more regulation.

By James Kwak
The Spam Filter

James Kwak  | 23 Jul 2009

The spam filter seems to be catching a few more legitimate comments than usual recently. I just rescued about nine comments (out of over one hundred messages flagged as spam) from the last several days. Some of those comments were from some of our most regular commenters. I know that if you put in a lot of links your comment is more likely to be flagged. Besides that I don’t really know what it is looking for.

If your comment does not appear, feel free to email me to look into it. I do get a lot of email, but if you are a regular commenter I will try to look into it as soon as I can.

By James Kwak
Bernanke And The Lobbies: Confidence Illusion

Simon Johnson | 23 Jul 2009

Ben Bernanke is opposed to the creation of a new Consumer Financial Protection Agency. Disregarding his organization’s disappointing track record in this regard, he claims that the Fed can handle this issue perfectly well going forward.

He thus adds his voice to the cacophony of financial sector lobbyists favoring the status quo.

At the same time, Bernanke and the lobbyists talk about the importance of consumer confidence for the recovery. But how can you expect anyone to have confidence enough to spend and borrow when so many people have been so badly treated by the financial sector in recent years?

What happens when there is a scare regarding food contamination in the US or globally? People buy less of that kind of food until the government assures them that (1) we know understand the cause of the problem, and (2) it will not happen again.

Word has got around that many financial products are not safe – as well as the idea that the debt levels encouraged by the finance industry are not always healthy. Consumers are going to be more careful and, if there is no way to reassure them fully, they may be excessively careful.

In addition, we have learned that allowing financial firms to abuse consumers is very bad for our overall financial system health – leading directly to the current crisis, loss of jobs, and still rising unemployment; all of this further undermines confidence of all kinds. If the financial system can turn nasty or even nastier, we should all carry more “precautionary” savings.

There’s no question that some financial firms would like to return to abusive practices, figuring they can once again make money and then move on. Yet serious financial sector firms would prefer to clean up their acts and work with properly informed customers. These firms are making a bad mistake in opposing the CFPA.

If the CFPA does not make it through Congress – and right now it seems a toss-up – this will just feed the backlash against finance more generally, e.g., in the 2010 midterm elections and beyond. There is no way that is good for overall confidence. It just doesn’t make sense for well-run financial firms to go down this road.
Industry thought leaders, the American Bankers’ Association, the Financial Services Roundtable, and other interest groups should switch their positions and support the CFPA – if they really want consumer confidence in financial products and more generally to return.

The Fed, it seems, just wants to defend its turf. This is unfortunate, particularly given its ambition to become even more responsible for the safety and soundness of the entire financial system. How can our financial system ever be sound when so many elements prey on so many consumers’ confidence?

By Simon Johnson

(The material after the break is an excerpt from my Economix column on NYT.com this morning.)
Mixed Messages

James Kwak | 23 Jul 2009

David Wessel seems to be doing the impossible: his book, In Fed We Trust, is getting mentions from all over the Internet, even before its publication, despite competition from what seem like dozens of other crisis books. That’s what a good PR campaign (and a good review from Michiko Kakutani) will do for you.

I obviously haven’t read the book yet, but I was interested in this description in Bloomberg:

None of the senior government policy makers anticipated the credit-market collapse that followed Lehman’s bankruptcy filing in the early hours of Sept. 15, according to Wessel’s book. . . .

On a conference call the previous week, Paulson, Bernanke, Securities and Exchange Commission Chairman Christopher Cox, and senior staff members from those agencies had agreed that companies and investors who did business with Lehman had learned from Bear Stearns and would have acted to protect themselves from a Lehman failure, Wessel wrote.

What were they supposed to learn from Bear Stearns? That they should be very, very afraid of a major bank failure and take steps to protect themselves? Or that the government would step in, so that even if shareholders were largely wiped out, counterparties would be protected? It seems like more of them drew the latter conclusion, even though Paulson, Bernanke, et al. wanted them to draw the former conclusion.

This seems to me an illustration of the fact that you can never be sure what message you are sending. Perversely, even letting Lehman fail ultimately convinced market participants that the government would step in the next time – because the damage done by Lehman’s collapse was so great. One-off intervention are a crude and risky way of communicating policy and creating incentives.

By James Kwak
After Peak Finance: Larry Summers’ Bubble

Simon Johnson | 24 Jul 2009

There are three kinds of “bubbles” - a term often used loosely when asset prices rise a great deal and then fall sharply, without an obvious corresponding shift in “fundamentals”.

1. A short-run bubble. Think about 17th century Dutch Tulip Mania: spectacular, probably disruptive, but not a major reason for the decline of the Netherlands as a global power.

2. A distorting bubble. In this case, the increase in asset prices contributes to a reallocation of resources across sectors. Think of the Dot-com Bubble: fortunes were made and lost, the collapse was scary to many, and – at the end of the day – you’ve built the Internet and some good companies.

3. A political bubble. Here rising asset prices generate resources that can be fed into the political process, through bribes, building politicians’ careers, and lobbying of all kinds. Bubbles in Emerging Markets often generate resources that impact the political process, sometimes in good ways – but most often in bad ways, which eventually contribute to a collapse.

Larry Summers seems to think we are dealing with the consequences of bubble type #1. In his speech last week, “the bubble” is a modern deus ex machina – it explains why we have a crisis, but there is no explanation of where this bubble came from, what exactly was bubbling, and what changes this bubble brought to the real economy or to our politics.

To the extent that Summers talks about the bubble at all, it seems to be in residential real estate. It’s hard to argue that there was an unsustainable run-up in housing prices and that the fall has real consequences. But what model – or even story – can explain the size of the global disruption we are facing without reference to what happened specifically in the financial sector?

The overall official consensus - which Summers continues to shape – seems to be that our problems are: housing bubble plus bad management in a few big financial firms and slightly too weak regulation. So we’ll tweak regulation, ever so gently, and let the “good” big firms gobble up the people, market share, and perhaps even assets of those that fall by the wayside.

But what if we are looking at the effects of a distorting bubble? In previous formulations – but not last week – Summers acknowledged that
when financial sector profits hit 40 percent of total corporate profits, a few years ago, we should have seen that as a “warning sign”. But was this a warning sign of something just about houses, or more broadly about the financial process in and around securitization that was both feeding the housing price increase and also reflecting a longer-run shift of resources into the financial sector?

Even James Surowiecki, a most articulate defender of our current financial sector, implicitly concedes that as a percent of GDP, finance is likely to fall from around 8 percent to GDP back towards 6 percent of GDP (its level of the mid-1990s; see slide 19 in my recent presentation; update, this link now fixed). Of course, there is no way to know exactly where finance is heading – except that it is likely down as a share of the economy.

If the bubble (or metaboom with a series of bubbles) was in finance and pulled resources into that sector, we face an adjustment away from Peak Finance – and perhaps this will even more overshadow the next decade than Peak Oil.

The economic adjustment will not be easy for the U.S. but it will be much more painful for smaller countries that have specialized in finance. The U.S., however, will likely struggle with the political adjustment – the financiers will not easily give up their licence to extract resources from citizens, either directly or through newly found rents channeled through the state (and coming ultimately out of your pocket, of course).

The political consequences of Peak Finance greatly complicate our economic recovery.

*By Simon Johnson*
Soaking Customers as a Form of Prudential Regulation

James Kwak  |  24 Jul 2009

Good for Deputy Treasury Secretary (and YLS alumnus) Neal Wolin for wading into the American Bankers Association to defend the Consumer Financial Protection Agency. According to FinReg21’s article:

Wolin firmly rejected the argument made by American Bankers Association chief executive Ed Yingling in recent congressional testimony that responsibility for consumer protection should not be separated from the responsibility for safety and soundness. . . .

The industry has argued that prudential regulators are careful to preserve a profit margin on financial products, to keep financial institutions sound.

This is a staggeringly cynical argument. Basically it says that you should combine prudential (solvency) and consumer safety regulation because otherwise the consumer safety regulators will reduce profits to the point where banks will not make enough money to be healthy. This logically implies that if there is a banking product or practice that is unsafe for consumers, but whose elimination would threaten banking profits, you should allow that product or practice. Is this really what the industry means?

I couldn’t believe anyone would actually say this, so I tried to find a source. I looked in the most obvious place, which was Ed Yingling’s July 14 testimony before the Senate Banking Committee. To his credit, I couldn’t find that argument in all its brazen glory. However, I did find torrents of partial truths like this one attempting to make the same argument:

Consumer protection and financial system safety and soundness are two sides of the same coin. Poor underwriting, and in some cases fraudulent underwriting, by mortgage brokers, which failed to consider the individual’s ability to repay, set in motion an avalanche of loans that were destined to default. Good underwriting is the essence of both good consumer protection and good safety and soundness regulation.
Note in passing that the spokesman of the American Bankers Association places all the blame on “mortgage brokers.” More importantly, what Yingling leaves out is that from the perspective of the individual bank there is no contradiction between fleecing customers and making lots of profits (which is what makes you safe and sound). (a) Originate bad loans; (b) pocket fees; (c) sell bad loans to an investment bank for distribution; (d) repeat. What threatened to bring down banks was the fact that they held on to too much of the risk of those loans, either on their balance sheets or in their off-balance-sheet entities.

Yingling’s testimony is page after page of that. This is going to be a real battle.

By James Kwak
But What Does It Mean for Me?

James Kwak | 25 Jul 2009

I’ve gotten a couple questions along the lines of: What do the crisis, the recession, and the recovery (of the banking sector) mean for ordinary people? I don’t think there’s any systematic way to answer this question, so I will simply offer some observations and guesses.

The material standard of living will not improve much for a while. Median real household income in the U.S. had already been stagnant for a decade, peaking in 1999 and spending all of this decade slightly below that level. The current recession is sure to drive that number down. Unemployment is up around 10% and seems likely to continue rising (unemployment is a lagging indicator, since businesses will first give existing employees more hours before they hire new workers), which will constrain wage growth (which was already constrained, presumably by globalization, for quite some time).

Median real household net worth, which did increase significantly in the last several years, is probably back down to 1990s levels, based on a little analysis of the Fed’s Survey of Consumer Finances. For that to go up, housing prices have to up up again. On that question, take a look at housing prices in historical perspective. We’re probably 30% down from the peak, but there’s no fundamental reason why housing prices have to stay where they are or go up from here. The other thing that could help out household net worth would be a rising stock market. That’s plausible, since the lower the level of the market the more likely it is to go up (all other things being equal). But I’m enough of a believer in efficient markets to think that you can’t expect more than the historical real rate of return (about 6%) – which would imply that the S&P 500 would reach its 2007 highs around 2021. (That’s assuming a 2% dividend yield and 4% real annual increase in the index itself.)

What about that economic recovery? I’m no macroeconomic forecaster – I believe some people build models with hundreds or thousands of variables – so take this for what it’s worth. Although the economy may start growing later this year, it is at a relatively low level – it will probably have contracted something like 4% when all is said and done. Now according to ordinary models, when the economy has contracted that much, there are built-in mechanisms that cause it to grow faster than its usual trend rate. For example, businesses have spare capacity, and employees can’t demand higher wages, so the marginal cost of
production goes down (businesses can produce more stuff without having to invest in new factories); and if costs are lower, businesses can either lower prices to stimulate demand, or they can make higher profits with which to expand. Similarly, if the economy is slow, people and businesses aren’t investing, so there is lower demand for money, so the price of money (interest rates) falls – to the point where people start borrowing and investing again.

The question is whether we can count on these mechanisms, and there is reason for skepticism.

The idea that you can stimulate consumption by reducing prices or by increasing income presumes a rational consumer who is balancing the utility of money against the utility of the stuff he can buy. Lower the price of the flat-screen TV enough, or give the consumer more income, and he will buy it. However, I suspect that the recession has changed at least some households’ attitudes toward consumption in a discontinuous way. People have always used certain shortcuts in mental accounting; money falls into various buckets, each of which is managed according to different rules. The rapid increase in the savings rate implies that people are putting a lot more money into the “do not consume no matter what” bucket, which is not responsive to ordinary economic incentives. Put another way, the productive side of our economy may be able to climb back to its potential output, but that depends on somebody buying all that stuff – and it will be a long time before China can pick up that slack.

So if I had to guess, I would imagine we’ll see moderately high unemployment for several years, reinforced by political opposition to more fiscal stimulus and by the increasing weight given to the national debt. One consequence of the recession and the huge increase in the budget deficit (and also of the last eight years of large budget deficits) is that we can’t even get universal health coverage without a majority of the political spectrum insisting it has to be deficit-neutral. In those circumstances, it seems highly unlikely that there will be political willingness to spend money for something so mundane as reducing unemployment.

What about all these bank profits? In the short term, I don’t see bank profits particularly helping or hurting ordinary people. We certainly aren’t enjoying any of them (except insofar as we own bank stock, but the median American has relatively little stock, and it’s already fallen 35% in value). But nor are they likely to trickle down, unless you have a house in the Hamptons to sell. The banks are making a lot of money on
things like fixed income trading and equity underwriting; apparently a major source of profits for the leading investment banks was underwriting equity being issued by other banks to fill their capital holes. All this cash rushing in is being used to shore up bank balance sheets to protect them against the ongoing devastation in both residential and increasingly commercial mortgages. (See Bloomberg on the need for greater provisions against bad loans; hat tip Calculated Risk.) If the banks can make money fast enough to compensate for the toxic assets they never got rid of – which is the administration strategy – then that is good in that it reduces the risk of another financial system panic. But I haven’t seen much evidence that banking profits are being used to expand lending into the real economy.

In the longer term, of course, the recovery of the banks will put the financial system exactly back where it was ten years ago, only with a few fewer banks (that is, more concentration). Hopefully we’ll also have a Consumer Financial Protection Agency, which should help protect people from particularly unsuitable financial products. Regulators will be a little more on their guard, and may have a few more powers at the margin. But the basic outlines of the system will be the same.

*By James Kwak*
Obfuscating Inequality

James Kwak | 25 Jul 2009

Will Wilkinson has gotten a lot of Internet love for his article “Thinking Clearly About Economic Inequality” (Free Exchange, Real Time Economics, Yglesias, Klein, Cowen, Rortybomb), which argues that increasing inequality is not as bad as people like Paul Krugman make it out to be. I thought it was a rhetorically clever but deeply misleading attempt to blur the obvious issue – economic inequality is increasing – by looking at it through a dizzying array of qualifying lenses.

Wilkinson marshals an impressive number of arguments to try to make the point that increasing income inequality is not the metric that we should focus on. I’ll try to take them one at a time. (Wilkinson’s arguments are summarized in the numbered paragraphs; the others are my responses.)

1. It isn’t income that matters, but consumption, since the way that income translates into utility is through consumption. “Why do we want income at all? So we can acquire things that we value.”

   OK, I guess, although this ignores the desire of rich people – or even moderately well-off people – to provide for their children. Besides the psychological utility that they gain, this just means that the imbalance in consumption between rich and poor will be spread across future generations. The imbalance doesn’t go away. But this argument isn’t the big problem.

2. Actually we need to look at lifetime consumption, because people engage in consumption-smoothing. And “the run-up in consumption inequality has been considerably less dramatic than the run-up in income inequality.”

   First, Wilkinson’s quotation seems to acknowledge that consumption inequality has been increasing. Second, you would expect increases in consumption inequality to lag increases in income inequality. When rich people get much, much richer very quickly – as happened in the last decade – they are not going to be able to consume that increased income as fast as they earn it. It will get deferred, or inherited, and will show up later. Poor people, by contrast, will attempt to maintain their consumption even as their incomes fall, going into more debt. This is why increases in consumption inequality lag increases in income inequality. It’s not a good thing.
Even more simply, if I make more money than you do over my entire lifetime, then over the course of my lifetime I will consume more than you (or my children will consume more than yours). Unless Wilkinson thinks that today’s successful hedge fund managers are actually going to be extremely poor in future years, this effect will not go away.

3. Furthermore, when we value consumption, we can’t look at market prices (nominal consumption); instead, we want to know the value to the consumer of the consumption. So instead we should just look at happiness. And here happiness gaps have been shrinking, not rising.

Wilkinson is honest enough to acknowledge that even the Stevenson and Wolfers study he cites for narrowing happiness gaps over the past several decades also found that “the trend toward greater equality in happiness stalled and began to reverse course in the 1990s, due in part to widening inequalities in happiness (and wages) between individuals of unequal levels of education.” And this is the period Krugman is most concerned with. But he then ignores this point in his analysis.

I’m as much a fan of positive psychology and happiness research as anyone. I am a believer, based on both personal experience and on reading summaries of the research (I’m not a research psychologist myself, of course) that above a certain level of income and wealth – which I would put somewhere squarely in the middle class – money simply does not make you happier. But this is the first time I’ve heard an economist try to justify economic inequality on the grounds that it is happiness that matters, not money. This is what you would expect from the medieval Church, not the Cato Institute: although you think you want more material things, actually you don’t, because the only thing that matters is salvation in the afterlife.

4. Wilkinson then tries to explain why increased income inequality does not translate into increased happiness inequality (although Steven and Wolfers actually say that it has translated into increased happiness inequality since the 1990s). There are two parts to this argument, but basically they collapse down to one. First, he says that the quality of budget-level products has increased faster than the quality of luxury-level products (like refrigerators), so that the differential in material comfort is decreasing for a given differential in monetary consumption. Second, he says that rich people are actually taxing themselves by spending huge amounts of money on “real estate with ocean views, or Ivy League diplomas, or goods like yachts” that do not provide value commensurate to their cost. (Along the way, he gets in a dig at the
luxury goods industry, which he claims provides shoddy quality at extravagant prices, but that seems to me like an anecdote at best; after all, a Park Avenue duplex is still a lot better than a studio in Yonkers, whether or not Hermes scarves are as good as they once were.)

First off, remember that we’re talking about changes here – changes in income gaps, in consumption gaps, and in happiness gaps. Wilkinson’s argument, that increasing income gaps coexist with decreasing happiness gaps, requires more than just the observation that happiness as a function has a decreasing slope (doubling your consumption doesn’t double your happiness). It requires some evidence that the marginal happiness benefit of consumption is decreasing over time. If the shape of the happiness curve is the same in time 0 and time 1, then increasing consumption gaps will produce increasing happiness gaps, though perhaps not at a linear rate. Increasing consumption gaps can coexist with decreasing happiness gaps only if the happiness curve is getting flatter fast enough to compensate for those increasing consumption gaps.

And here Wilkinson undercuts his own argument. He points to the relatively small practical difference between a $300 refrigerator and a $10,000 refrigerator, which is far bigger than the difference between no refrigerator and a refrigerator – which was the relevant difference maybe fifty years ago. Good point. But he also talks about how vanilla and pepper suffered the same fate – only much longer before. The lesson is that different products and services that people want change over time, and at different times, from being rare luxuries to being relative commodities. Just because one former luxury good is now a commodity good doesn’t mean there aren’t other valuable goods that many people cannot afford.

Take organic fruits and vegetables, for example, which many parents would like to buy for their children, but are simply too expensive for tens of millions of households. Or private school in places where the public schools are not very good. Or being able to move out of an area that is plagued by air pollution, or by crime. These are not frivolous luxuries like Sub-Zero refrigerators. Or even take air travel, which has gotten much cheaper over the past three decades and that we commonly think of as having been “democratized.” Flying a family of four even just from the Northeast to Orlando can easily cost $2,000 in air tickets alone – something that is far beyond the reach of many families who would love to take their children to Disney World just once in their childhoods. In short, for all the product categories where you can say the rich are wasting their money on Sub-Zero refrigerators, there are other product
categories where having more money makes a big, big difference in your material quality of life.

And let’s not mention health care, which is literally a matter of life and death.

Finally, there’s something strangely patronizing about this argument. Wilkinson cites research showing that the rate of inflation for the basic necessities that poor people buy – food, shelter, clothing – has been lower than the rate of inflation for other goods, like “home cleaning, lawn care, psychotherapy, and yoga classes.” That is an important finding. The implication is that, relatively speaking, the buying power of the poor (and hence their consumption) has grown faster than their income, while the buying power of the rich has grown slower than their income.

If the falling relative price of basic necessities (other than health care, of course) has reduced the proportion of people who go without basic necessities, then that is a great thing. But that is not the same thing as a decrease in inequality. Whether or not the poor have what social scientists think they need – food, shelter, and clothing (but not health care!) – they may still want home cleaning, lawn care, psychotherapy, and yoga classes. In this model, more leisure time, better psychological balance, and less back pain are all valuable things that rich people have much more of than poor people. And no matter what you do with the numbers, if nominal consumption inequality (inequality in the amount spent on consumption) is going up, you cannot make inequality in consumption of these goods go down. In a simple model, rich people benefit the same amount in nominal terms as poor people from a fall in the price of necessities, and therefore if the nominal consumption gap is increasing, the gap in the amount of money left for yoga classes is necessarily also increasing; the rate of inflation of yoga classes cannot change that. Given an increasing nominal consumption gap, rich people may have a lower percentage rate of growth of abstract consumption units than poor people, but their level of consumption will always grow faster than that of poor people.

Ultimately, the “rich people are fooling themselves” argument relies on a theory of false consciousness: rich people don’t know what is good for them and are wasting their money; poor people are better off not taking yoga classes. But this, I fear, moves us out of the realm of economics altogether. I know that behavioral economists for decades have been showing that people make irrational choices. Fine; let’s try to
help people make more rational choices. But remember, it’s still their money. And they want more of it. How people spend their money reveals how they value things, and if they pay $50 per hour for yoga classes, then maybe yoga classes are worth $50 per hour to them, at least in their conscious brains.

From a moral standpoint, if there is a problem in one person having ten times as much money as someone else, that problem does not go away because he blows it on cocaine. From a policy standpoint, whether or not people use their money in ways that increase their happiness, money is the thing that they care about, and trying to base policy decisions on happiness is both paternalistic and impractical. If it turns out that rich people are no happier than poor people, should we simply stop worrying about poverty?

Wilkinson brings up a lot of interesting ideas and cites some interesting research, but does little to challenge Krugman’s core point: people like money, people use money to buy stuff, the money gap between rich and poor is increasing, and the stuff gap is increasing as well. I’ll accept that nominal consumption inequality may be growing slower than income inequality (although I suspect the difference is just being deferred into later decades), and inequality in stuff actually consumed may be growing slower than nominal consumption inequality (due to different inflation rates), but I don’t see a solid argument for why they aren’t growing. And that’s still a problem.

That was just the first nine pages – hopefully I’ll be back to talk about the rest.

By James Kwak
Health Insurance “Innovation”

James Kwak | 27 Jul 2009

The This American Life crew, once again proving that they can cover any topic they want better than anyone else in the media,* has a segment in this weekend’s episode on rescission of health insurance policies – insurers’ established practice of looking for ways to invalidate policies once it turns out that the insured actually needs significant medical care. (The segment is around the 30-minute mark; audio should be available on that page sometime on Monday.) The story describes a couple of particularly egregious cases, such as a woman who was denied breast cancer surgery because she had been treated for acne in the past, and a person whose policy was rescinded because his insurance agent had incorrectly entered his weight on the application form.

The legal basis for rescission is that when you sign an insurance application, you are warranting that the information on the application is true; if it turns out not to be true, the insurer can get out of your insurance contract. It’s particularly nasty in practice because the insurer does not immediately investigate your application to determine if it is accurate before selling you the policy (that would be impractically expensive); instead, the insurer waits – years, in many cases – until you actually need expensive health care, and then does the investigation, which at that point is worth it because of the payments the insurer could potentially avoid. Also, you can lose your coverage for innocent mistakes, which are easy to make since the application form asks you if you have ever seen a doctor for any one of a long list of medical conditions that you are certain not to recognize or understand. (In a Congressional hearing, the CEO of a health insurer admitted that he did not know what several of the conditions listed on his company’s application were.)

This reminded me of nothing so much as all of those “innovations” created by credit card companies, such as universal default, penalty rates, and double-cycle billing, which are really just ways to generate fees that you are unlikely to accurately estimate at the time you sign up for the card. It’s legal; it makes more money for the insurer (or credit card issuer); once one company does it, other companies have to, or they won’t be able to compete; it’s disclosed in such a way that customers don’t understand what they are getting into; it nails you when can least afford it; and it even has a plausible economic justification. Credit card issuers claim that their arsenal of hidden fees makes the cost of credit
more closely reflect the riskiness of the borrower, and without the fees they would have to charge higher interest to everyone; health insurers claim that rescission is necessary to deter fraudulent applications, and presumably without it they would have to charge higher premiums to everyone.

Also, it’s definitely an innovation. I’m sure health insurers have always had fraud investigation units, which looked for red flags on new insurance applications to identify suspicious customers. But the idea that you should (a) target customers precisely because they get sick and need health care and (b) go after them for innocent mistakes is not an inherent part of the insurance business, and is something that some clever person came up with as a way to make more money – not a way to provide more coverage or better service to customers at lower cost.

And it’s terrible. Basically, anyone who had to fill out a medical underwriting application to get health insurance (this is basically the individual market, not the group market that people are in if they get insurance through their employers) is at risk of finding out that that insurance doesn’t actually exist precisely when he or she needs it most. The insurers claim that rescission is very rare; at the Congressional hearing, two of three industry representatives said it happens to less than 0.5% of policies per year. But that is a deeply misleading number. That means that if you are in the individual market for twenty years, you have a 10% chance of your policy being rescinded; 30 years, and it goes up to 14%. There is a big difference between health insurance and a 90% chance of having health insurance. And remember, insurers only try to rescind policies if you turn out to need them; so the percentage of people who lose their policies when they need them is even higher. (The denominator should exclude all those people who never need expensive medical care, at least not before 65 when they go onto the single-payer system.)

I know that rescission does not logically prove that some private health insurance system cannot work. For one thing, Congress could simply pass a law banning the practice except in cases of intentional misrepresentation (although the free marketers would complain about increasing government interference in the “free market”). But it is evidence that the private health insurance system we have does not work. Yes, it’s just the individual market, but it’s the individual market that’s growing, not the employer-based market. And the system we’ve got, like the credit card industry, is one where the name of the game is finding ways to make the product you sell worth less to the customer than the
customer thinks it is worth. (The more common way this is done is by burying exclusions and limits in the fine print.)

This is the system that the politicians who are dug in against health care reform – and everyone knows who they are – are defending. I’d like to see them try to defend it openly, instead of hiding behind the tattered banner of fiscal responsibility.

* OK, that may be a bit of an exaggeration. I am really a huge fan, so I get carried away sometimes.

Update: Some days the Internet can be scary. I just peeked and noticed that The Huffington Post has sent over about 40,000 views to this post in the last few hours. The HuffPost excerpt focused on the two horror stories I mentioned at the end of the first paragraph which, I want to be clear, I did nothing to help uncover; they were raised in a Congressional hearing and then picked up by This American Life.

Since my late-night musings on rescission are getting more attention than they deserve, I want to point you to other discussions of the topic that probably got less attention than they deserve. First, the transcripts of the House Energy and Commerce Committee hearing that is quoted by This American Life are available here. The same committee is having another hearing on the topic today. Second, at least two bloggers picked up the story when it happened back in June: Kevin Drum and Ezra Klein. For those who don’t want to read all the hearing transcripts, Drum linked to this Los Angeles Times story. Finally, one expert on the topic is Wendell Potter; his appearance with Bill Moyers is excerpted by Mark Thoma.

By James Kwak
On Monday and Tuesday of this week, Treasury Secretary Geithner – and Secretary of State Clinton - meet with a high-level Chinese delegation. (Could someone please update the Treasury’s schedule of events? At 7am on Monday it still shows last week’s agenda; update, 9am, this is now fixed – thanks).

According to official previews (i.e., the apparent contents of background briefings given to wire services), the economic topics are China’s concerns about the value of the dollar (i.e., their investments in the U.S.) and the amount of debt that the U.S. will issue this year.

This is absurd.

China decided to accumulate over $2trn worth of reserves, most of which they are presumed to hold in dollars. No one compelled, suggested, or was even particularly pleased by their massive current account surplus (peaked at 11% of GDP in 2007, but still projected at 9.5% of GDP for 2009). We can argue about whether this surplus - arguably the largest on modern record for a major country – was intentional or the result of various policy accidents.

Irrespective of underlying cause, any country that runs such a current account surplus is implicitly taking a great deal of currency risk – China was in effect deciding to take the biggest ever official long-dollar position. The idea that the US government should spend time reassuring them is somewhere between quaint and not good strategy.

If China decides to now shift out of dollars, what would happen? Remember that the US left the world of fixed exchange rates and associated rigidities a long time ago – back in the early 1970s. The dollar would surely depreciate and inflation would likely rise. But who cares?

A weaker dollar would help our exports. It’s not honorable for the issuer of a reserve currency to talk down its own exchange rate (hence the Rubinesque “strong dollar” rhetorical trap), but if a third party leads a big sell-off, what can we do about it?

Treasury’s concern is not really the value of the dollar – particularly as they would like a bit of inflation at this point; again, if it’s China’s fault that the real value of our debts falls, that might play (or spin) well in Peoria. Instead, Treasury’s concern is the large amount of debt that they/we are trying to issue.
If China is worried about the future value of our debt in renminbi, then Treasury will have to pay higher long term interest rates. But, as Treasury and the White House have been emphasizing, what really matters for our long-term fiscal solvency is bringing Medicare and associated costs under control. Any strategy that relies instead on indefinitely low long-term interest rates is illusory – and any investor who thinks we will be like Japan in this regard is in for some disappointment.

The real issue for discussion this week should be China’s current account surplus and the pressing actions needed to bring this under control. The US should put on the table the possibility of more assertively taking China to the World Trade Organization over its fundamentally undervalued exchange rate and associated trade policies (Arvind Subramanian’s idea). The exchange rate dimension should have been dealt with by the IMF, but unfortunately that organization has (again) ducked its responsibilities on this issue.

The Treasury apparently thinks it should be deferential and on the defensive vis-a-vis China. This is not only bad economics, this is bad geopolitical strategy.

By Simon Johnson
Jeb Hensarling, George Orwell

Simon Johnson | 28 Jul 2009

The debate over re-regulation of the financial sector has finally, and irreversibly, turned partisan. This helps define issues in ways that may be more familiar and thus easier to understand.

In the blue corner we have Treasury Secretary Tim Geithner. Secretary Geithner’s overall banking policy continues to be problematic, and his broader re-regulation effort is hampered by all the free passes he gave to bank CEOs earlier this year. But on consumer protection he has the right message and he delivered it forcefully to Congress last week: we need a Consumer Financial Protection Agency (CFPA) and we need it now.

In the red corner, Representative Jeb Hensarling is rapidly emerging as a leader. A member of the Congressional Oversight Panel and the senior republican on the House Financial Services subcommittee on Financial Institutions and Consumer Credit, he wrote last week in the Washington Times that the CFPA is “Orwellian”, because it would strip consumers of their rightful choices.

Mr. Hensarling seems dangerously close to slipping into double think. He says that the House Republican “regulatory reform plan” will protect consumers. (This plan was not available for outside review when I enquired last week; if you have a copy that can be shared, please send it to me.) As far as I can see from his article – confirmed by what I heard before the House Financial Services Committee last week - the only tools they propose are those that have been tried and failed, repeatedly, in the recent past.

The key sentence in his op ed may be, “If we act responsibly, whether the mortgage blows up on us is largely within our control.” This ignores all the evidence that consumers were duped, misled, or otherwise fooled into financial products that they did not understand and could not afford.

Mr. Hensarling says that financial products are completely different from toasters, which are regulated by the Consumer Product Safety Commission, because “No one wants a toaster that will blow up, and whether it does is largely out of our control.” But regulation over consumer durables was introduced and tightened over the years precisely because the “free market” produced items that were unsafe (at any speed, or any toaster setting).
Mr. Hensarling claims that consumer protection will be very much against the interest of smaller companies. There is no evidence to support this assertion – and it seems implausible. Many smaller businesses have been scammed by Big Finance in the past few years – either directly, through the products they were sold, or indirectly, through the higher tax bill we all face as a result of bailing out the big banks.

And the bad behavior of big banks is closely connected to how the financial sector has been allowed – and is still allowed – to treat consumers.

Yesterday, at last, a major commercial bank CEO broke ranks and articulately made the case against the actions and structure of Big Finance, specifically Goldman Sachs - see Robert Wilmers, head of M &T Bank, writing in the Washington Post. Hopefully, the finance lobby will more generally follow his lead – both in speaking out against the dangers of the biggest banks (and their “innovations”) gone bad, as well as in favor of protecting valued consumers against outrageous scams.

If consumers don’t trust financial services – and why should they, given all we’ve seen? – this will be a long and painful recovery. Given what we know and have learned painfully about how our financial system operates, saying that “the market will provide consumer safety” is essentially the same thing as saying “the market will not provide” – you’re on your own, again.

*By Simon Johnson*
More on Rescissions

James Kwak  |  29 Jul 2009

For those interested in the issue of health insurance policy rescissions, Slate also had a story yesterday, only with a lot more detail and links than mine (but without the clever comparison to financial services “innovation”).

Also, Taunter wrote an insightful post about rescission, expanding on a comment he left on this blog. He drives home a point I thought I made in my original post, but maybe wasn’t very clear: if 0.5% of policies get rescinded, that means that far more than 0.5% of insureds who really need insurance get their policies rescinded, because the insurers are targeting those policyholders who develop expensive illnesses. I said, “insurers only try to rescind policies if you turn out to need them; so the percentage of people who lose their policies when they need them is even higher.” Taunter puts numbers behind that, and they turn out to be potentially scary.

He also has a great analogy to underage gambling which I will reproduce here:

Years ago I was walking a casino floor with a casino executive. . . . [T]here we were in the middle of acres of blinking lights, with absolutely no one making sure that underage kids weren’t walking up to a slot machine. Indeed, they don’t card for the table games.

The executive told me you are free to play if you are underage, you just aren’t free to win. You can sit down and pump your money into the slots, and if you look presentable you can drop some chips on blackjack or craps. However, if you should happen to start winning, the pit boss or security team will come over and check your ID. The house edge is 100%.

By James Kwak
Traditional Chicago Economics Under Pressure: Beyond The Thaler-Posner Debate

Simon Johnson | 29 Jul 2009

Richard Posner is against the proposed new Consumer Financial Protection Agency (CFPA). This is, of course, not a surprise. Posner has always been an articulate advocate of the view most often associated with economics at the University of Chicago: market-based outcomes are invariably better than the alternatives, and anything that interferes with consumer choice is a bad idea.

Posner wraps this opposition to the CFPA into an odd attack (near the end of his WSJ op ed) on the personal decision-making abilities of Richard Thaler – a leading economist on consumer choice, misperceptions, and mistakes. (More on Thaler here.)

Thaler, also of the University of Chicago, hit back hard yesterday. He is right that Posner mischaracterizes the CFPA proposal, and points out that his agenda – and that of Cass Sunstein, formerly of Chicago and now a czar in the administration – is simply to provide consumers with a framework for better decisions. He implies that Posner defends defective baby cribs and their equivalent.

I would go further.

Think of it this way. We’ve learned a great deal about how consumers make decisions, including when they get things right and wrong. Behavioral economics, marketing, and related social science have made big strides (e.g., follow the work of Dan Ariely).

But all of this research is also available to companies. Perhaps they knew some of this before from trial-and-error, but there is no question that many of the techniques corporate America uses – and we as consumers find ourselves “up against” – is cutting edge manipulation of our decisions.

We worry a great deal about how corporations lobby to shape their regulatory environment. This is a struggle that is at least 150 years old in its modern form (e.g., railroad concessions), and much older if we think about powerful people bribing their way into advantageous relationships with the state.

In addition, companies now have powerful new tools to shape how we perceive our potential choices. Some of these tools might be good for us also – I’m open to argument on this. But within some particular spaces,
including financial products, it’s clear that many of these “innovations” are actually clever ways to extract value from consumers.

Traditional Chicago economics always had its weaknesses – particularly when you focus on the fact that the “rules of the game” are often shaped by the more powerful. Thaler and Sunstein (and others) are trying to modernize this view more generally, while keeping the element of consumer choice as central.

But if the balance of power has shifted – due to technological innovation in social science – further towards corporations and away from consumers, then the task ahead is much harder.

Unless companies are compelled to keep their offerings “simple enough to understand”, we will face repeated rip-offs and crises – both macroeconomic and personal – arising from our financial sector.

By Simon Johnson
The Case for Capital Controls, Again

Simon Johnson  | 30 Jul 2009

If you are in charge of monetary policy in an up-and-coming Asian economy (say India, China, or Korea), you have a problem.

The world’s financial markets have decided that Asia is rebounding more quickly than most other parts of the world, and capital is rushing to get into those countries before asset prices rise too much.

The monetary policy authorities know this and – given what we have all seen over the past few years (or is that two decades?) – they are rightly worried about new “bubbles” of various kinds that can destabilize their financial systems and undermine their economies.

What should these central banks do? If you fear that your economy is growing too fast, and thus inflation is on the rise, responsible central bank mantra dictates that you should raise interest rates. The same mantra was, in the era of Alan Greenspan, less clear on whether interest rates should be increased to forestall unsustainable financial bubbles. With the puncturing of the Great American Bubble, including the fall of Greenspan as an icon, most central bankers are quietly quite willing to tighten monetary policy if they see real estate prices take off like a rocket.

But this is exactly where the problem lies.

If you raise interest rates in an economy open to capital flows, at the same time as the world’s money centers have low or almost zero interest rates, what happens?

Almost certainly, you will attract more capital from overseas. This capital inflow will likely feed into your domestic credit boom and further the run-up in asset prices, housing construction, and other bubble-related phenomena.

Some of these consequences can be offset if you let your currency appreciate, i.e., rise in value as the capital comes in. But most Asian countries, most particularly China, generally resist such appreciation, in order to protect their export industries; so this “feedback” or dampening mechanism is removed. And the more you resist appreciation by accumulating foreign exchange reserves, the more investors believe they will make money on a future rise in the value of your currency. So the more they want to pile into your markets.

What should Asian central bankers do and why should we care?
One view, increasingly part of the mainstream consensus, is that these central banks should tighten up on lending standards and otherwise lean on banks to lend less as capital comes in. This is not a terrible idea – the US, of course, loosened lending standards during its real estate boom, and we know how that ends.

But are such ad hoc adjustments around the edges of the regulatory system likely to be enough, given the scale of capital inflows?

Much more likely is what is now being whispered about in the corridors of financial power – begin to consider ways to tighten capital controls, i.e., limit the amount of capital that can come into a country, or force investors to commit to stay in the country for longer periods of time.

Such capital controls are unlikely to be announced explicitly, but watch for tightening the rules around inflows. And expect discussion increasingly at the level of the G20 about the extent to which various kinds of capital controls can now be considered “best practice.”

The US has historically pushed the view that all capital controls are bad and should be abolished – in fact, this was a major international policy initiative of the Clinton administration, led in this regard by Messrs. Summers and Geithner (who both came up through the international side of Treasury).

But given our more recent record of mismanaging financial markets and dealing with instability, as well as new retrospectives on the string of international financial crises we have experienced since the 1980s, the Obama administration is not in a strong position to block further moves towards capital controls.

For better or worse, we are likely heading towards a world in which capital no longer flows so freely across borders. Look for the start of this in Asia.

By Simon Johnson

This post is reproduced with permission from the New York Times Economix blog. Anyone who would like to reproduce this post in its entirety should seek permission from the New York Times. Standard fair use rules apply for short quotations; please link back to the original post on Economix.
Stephen Carter, one of my best professors at law school and also an accomplished novelist, has an op-ed in today’s Washington Post arguing that high corporate profits are a good thing, and as a consequence we need to have a strong and profitable for-profit health insurance sector. Here’s the essence of his argument:

High profits are excellent news. When corporate earnings reach record levels, we should be celebrating. The only way a firm can make money is to sell people what they want at a price they are willing to pay. If a firm makes lots of money, lots of people are getting what they want.

I agree that the pursuit of high profits is a good thing. That is what makes a free-market capitalist system work, and it’s what made me start a company eight years ago. But basic microeconomics says that high profits themselves are generally not a good thing.

In a competitive market, if one company is earning high profits, then other people will want to start new companies to compete with it. By entering the market, they increase competition, reducing profit margins for the original market leader; more companies and more competition also mean more innovation; both of these factors increase overall social welfare. In a true competitive market, one without barriers to entry or market power, companies should not earn any profits at all, because competition will drive price down to marginal cost. (Steve Goldman, one of my economics professors, once said that if you wake an economist up in the middle of the night and ask him or her, “what is price?,” he should answer, “marginal cost.”)

The real world is different, of course. Companies have to earn profits sufficient to cover their cost of capital. And if you invent a successful new product, you will earn excess profits for some period of time; but over time your competitors will catch up and those excess profits will go away (see the IBM personal computer, for example).

So if you see a company that has very high profits over a sustained period, there are two possibilities: either it is benefitting from a non-competitive market (e.g., it is a monopoly), or it is simply exceptional at innovating and staying ahead of the competition for years on end. If you
see a whole industry that has sustained high profits, however, the latter explanation cannot hold, and you should immediately suspect a lack of competition.

In short, the thing that we should celebrate is not high profits, but competition. The pursuit of high profits is what motivates competition; but if a whole industry achieves high profits, then what you are seeing is not competition, but its opposite.

Now what’s going on in health care? Look at page six of this report. In most states, the combined market share of the top two health insurers is well over sixty percent. That is not a competitive market, but a market controlled by one or two companies.

In addition, there are good reasons why a free market is not how you want to allocate health care anyway. For one thing, as I have argued, a free market for health care is a market in which sick people die, because no one will sell a sick person an insurance policy that costs less than his or her expected costs under the policy.

Second, as Paul Krugman explains, health care is a good that does not conform to the basic assumptions that you need for free markets to produce optimal solutions. I won’t try to summarize, since he already summarizes elegantly. But before you dismiss Krugman as a liberal pundit, note that his main source is a paper by Kenneth Arrow – as in the Arrow-Debreu Theory, the centerpiece of general equilibrium theory and of mainstream microeconomics in general in the last fifty years.

Now, it is perhaps possible that private health insurers could be part of a well-functioning health care system – if, for example, they were not allowed to engage in medical underwriting (which is what makes sick people unable to buy insurance at any price they can afford). But that’s not the system we have now. Instead, we have local oligopolies, and if they earn high profits, that’s a product of market power and lobbying clout, not “lots of people . . . getting what they want.” (Do you know anyone who actually buys insurance – either someone in the individual market or someone who buys insurance for an employer – who is happy about what he or she is getting these days?)

Obviously companies should make profits; the need to make profits is what separates good companies from bad ones. And people should be able to get rich making excess profits that result from innovation; you can make a lot of money in the period between the innovation and the competition catching up with you. But if you see sustained high profits
by an entire industry of corporate behemoths, you should be very, very worried.

By James Kwak
What Is Josef Ackermann’s Point?

Simon Johnson  | 31 Jul 2009

Writing in the Financial Times yesterday, Josef Ackermann – CEO of Deutsche Bank – argued that larger banks are not more dangerous to the health of financial system (and thus to taxpayers) than smaller banks. According to him, system danger arises primarily from the degree to which banks are “interconnected”.

Inadvertently, Mr. Ackermann makes a strong case for banking system reform. You can break this down into five parts.

1) There is no “either/or” structure to the discussion of size vs. interconnectedness vs. leverage vs. herding behavior of management. “All of the above” is a completely plausible answer, and Mr. Ackermann helps to make the case that relatively small banks also need to be addressed.

2) No doubt smaller banks will not be thrilled by his point – we should expect more Robert Wilmers-type diatribes, next time against Deutsche rather than Goldman. This, of course, is exactly the kind of division within bankers’ ranks that you need to push for meaningful reform. Divide and reregulate effectively, before they close ranks.

3) Mr. Ackermann nowhere mentions that Deutsche Bank’s leverage was, at its peak, judged by some market participants to be around 50:1, making it arguably the biggest hedge fund in world history. Deutsche’s response in 2008 was that such estimates were based on mismeasurement and its true leverage was “no higher than that of Citigroup.” Ouch.

4) Deutsche’s experience, its effective bailout by the German government, and the current misery of European banking more broadly emphasize the need for much stronger capital requirements across the board as part of our eventual response. Of course, these can be higher in percentage terms based on size, interconnectedness or anything else you want to worry about; but all of banking has become too dangerous (to your fiscal health). European-type loopholes, such as “off-balance sheet” activities, must be removed and – as Mr. Ackermann implicitly acknowledges – only action at the level of the G20 can really ensure cross-border bite on such rules.

5) Mr. Ackermann’s endorsement of the current G20 action plan is further confirmation that this plan does not constitute serious progress.
Unless and until you get agitated pushback from the world’s biggest bankers, your reform efforts are not real.

Interestingly and surprisingly, Ackermann also makes only a weak case for large banks (in his last paragraph, which seems tacked on awkwardly). If this is the best his staff can do, the case for very big banks is in no way compelling.

By Simon Johnson
The Value of (Not Having) the Public Plan

James Kwak  | 31 Jul 2009

This guest post was written by Arindrajit Dube, an economist at UC Berkeley Institute for Research on Labor and Employment who is joining the Department of Economics at the University of Massachusetts, Amherst. His work focuses on labor and health economics topics, as well as political economy.

Why have pivotal members of the Congress been reluctant to allow individuals the choice to buy into a public health insurance option? A political-economic reason is that the “bipartisan” group of six senators responds more to the interests of health insurance companies than public opinion, including the median voter. While this is hard to assess directly (although we do know they receive substantial campaign finance from insurance companies), we can however observe the effects of (a somewhat unanticipated) decision they made on those who stand to privately benefit from that decision.

Here is how the share prices of three major insurance companies (Cigna, United Healthcare Group, Aetna) responded on Tuesday, July 28 to the Monday night announcement that the group of six senators is going to eliminate the public option from their version of the health care reform legislation [graph produced using Yahoo Finance]. We have basically an 8-10 percent gain for these companies from the Senate announcement. And as the graph below shows, the S&P 500 index (yellow) was essentially flat. The market caps of these three companies together are around $53 billion, which suggests a $4-5 billion value from the announcement by the group of 6.

Since the change (due to the announcement) in the perceived probability of the public plan being instituted was less than 1 (i.e., it went from a middling number to a small number, as opposed to from a certain yes to a certain no), this is a lower bound estimate of the value to the insurers of protection from public sector competition – whatever the broader societal costs/benefits may be.

To get an estimate of the full value to insurance companies from killing the public option, we can use Intrade prediction markets to infer the unanticipated component of the Senate group of 6 announcement.

It appears that after the group of 6 announcement on July 28, the share price of the Intrade contract, “A federal government run health insurance plan to be approved before midnight ET 31 Dec 2009,” fell from around 45 to around 30, a roughly 15 point drop. This suggests the
true value to these insurance companies of not having a public option may be around 6.7 (=1/.15) times the $4-5 billion change due to the announcement, or around $28-35 billion dollars.

One can also use the prediction market more systematically to see how changes in the perceived odds of enactment of a public plan correlate with stock price returns for these three companies. Regression analysis confirms the qualitative findings from the event study analysis above, though the dollar value from protection is found to be more in the range of $10 billion. Below, I use the full set of daily Intrade (prediction market) data, available from June 10 when the contract originated. I also use daily closing stock price data for these three companies to construct “abnormal returns” (i.e., Raw Return – “beta” x S&P500 Return, where the market “beta” is taken from the Google Finance website). I then plot the (market cap weighted) mean “abnormal returns” against changes in the price of the Intrade contract.

The correlation coefficient is -0.33, and the slope of the regression line is -0.21 (standard error of 0.11). This suggests that a 10 percentage point increase in the probability of the public plan passing is associated with a 2 percent drop in the price of the stocks, and this is statistically significant at the 10 percent confidence level. If we are willing to extrapolate this, it would suggest an $11 billion (0.2 x $53 billion) gain for these companies from warding off a public option.

In summary, both the regression method as well as our event study method using the announcement by the group of 6 suggest large gains to insurance companies by avoiding competition with a public plan.

By Arindrajit Dube
Telecom “Innovation”

James Kwak | 31 Jul 2009

NewYork Times technology columnist David Pogue is mounting a campaign against those canned messages that cellular carriers play after the greeting on your mobile phone voicemail (hat tip Mark Thoma’s son) – you know, the ones that say “to leave a voice message, wait for the beep,” only they take 30 seconds doing so, for the sole purpose of chewing up the mobile phone minutes of the person calling you. (According to Pogue, multiple carrier executives have admitted that the sole purpose of these value-destroying messages is to maximize airtime and hence revenue.)

This is exactly the same kind of “innovation” that we’ve seen in financial services and in health insurance. In each case, it’s what you get when you have too much concentration, so that a small group of oligopolists can effectively agree on the same business practice that generates profits at the consumer’s expense.

In this case, it’s particularly dependent on there being an oligopoly, because implementing the practice doesn’t even make you any additional revenue. Because you’re chewing up the minutes of the person calling your customer, you’re actually helping one of your “competitors.” (If the caller is also your customer, then the airtime is probably free anyway.) The only reason to implement this practice is because you can count on your competitors reciprocating the favor, and they do. Once you reach that equilibrium, there is no reason for any of the big four carriers to do the consumer-friendly thing and eliminating the timewasting messages. And mobile phone service is an industry with particularly high barriers to entry, since at this point you would have to buy spectrum in all of the major national markets, and that spectrum is owned by the current oligopolists. So there’s no way someone could start a new, consumer-friendly cell phone carrier.

It’s also revealing that Apple forced AT&T not to impose the mandatory message on iPhone customers. Apple, as a company that actually cares about every detail of its customers’ experience, insisted that AT&T remove the messages. More importantly, Apple had a product that had even more market power than mobile phone service – the iPhone.

This is just more evidence that companies pursue profits in other ways than providing better goods and services that customers will pay more
for, and that many times they are successful – especially when you have concentrated market power, or you have products that consumers do not understand very well. If consumers cannot recognize the bad deal that is being forced on them, or if no one in the market has an incentive to offer them a better deal, then the bad deal can persist indefinitely, boosting profits and destroying value. The transfers of cash from customers to carriers does not destroy value – it’s just a transfer – but the fact that we all spend unnecessary time on the phone is a clear destruction of value or, to put it in economic terms, an inefficient outcome.

For the record, I’m proud to say that my voice mail greeting for several years has begun, “Hi, this is James. To skip this message press star . . .”

By James Kwak