The Baseline Scenario 2009-08

Updated: 5-4
Update this newspaper
August 2009

Who Is Too Big To Fail? (Weekend Comment Competition)

Simon Johnson  | 01 Aug 2009

In 2004, Brookings published “Too Big To Fail: The Hazards of Bank Bailouts” by Gary Stern and Ron Feldman (paperback edition 2009). There is a great deal of sensible thinking in this book, as well as much that now seems prescient – particularly as they have been presenting and publicly debating these ideas at least since 2000.

Some of it also seems a bit dated, but in an interesting way that tells us a great deal about how far we have come.

On the basis of their qualitative assessment, reading of the regulatory tea leaves, and a deep understanding of the available data, Stern and Feldman construct several lists of banks that may be considered (in 2004) Too Big To Fail. The most interesting names and numbers are in Box 4-1 (scroll to p.39 in this Google Books link) (update: or look at this pdf version), entitled Organizations Potentially Considered Large Complex Banking Organizations.

Here’s this weekend’s competition.

What strikes you about their list? Who do they miss and what can we infer from that? And should we, like them, also consider foreign banks active in the United States as potentially Too Big To Fail?

By Simon Johnson
Richard Thaler Explains Behavioral Economics to Richard Posner

James Kwak | 02 Aug 2009

Richard Posner, who usually shows at least some subtlety in his reasoning, trotted out all the usual Republican talking points against the Consumer Financial Protection Agency in the Wall Street Journal, choosing to attack Richard Thaler along the way for no apparent good reason. The core of his argument is that since Thaler has previously advocated investing a larger proportion of one’s portfolio in stocks, and this would have been a bad strategy in 2008, he cannot possibly be right when it comes to financial regulation. I’m not kidding – that’s the whole second half of the article. And Posner doesn’t even ask, let alone answer, the question of whether Thaler might have been right over a longer timeframe, say since 1993, when Thaler published the paper that he cites.

I was thinking about responding, but on the one hand I didn’t want to seem obsessed with Posner after my previous two posts, and on the other hand I couldn’t think of anything to say I hadn’t already said in my response to Peter Wallison, since Posner’s arguments are a subset of Wallison’s (except for the bizarre attack on Thaler).

Thaler solved my problem by responding himself on Paul Solman’s site (hat tip Mark Thoma). Enjoy.

By James Kwak
Why Don’t The Community Banks Get It?

Simon Johnson  |  03 Aug 2009

The continuing ability of Big Finance to play our elected representatives, and thus the taxpayer, should surprise no one. This is about organized money against relative diffuse public interests. It’s Mancur Olson’s Logic of Collective Action meets sophisticated media managers with experience in emerging market crises – they know that as long as you can look confident and pump in money, everything turns around and people forget (and then you can re-run the show).

More puzzling is the reluctance of other well-organized interest groups to act against Big Finance. In particular, powerful business groups – like Independent Community Bankers of America - understand very well what happened and the way in which are largest banks were responsible. Yet they refuse to push for regulatory reform, either in broad terms or with regard to consumer protection (e.g., see their policy statements; recent testimony).

Their reasoning is fascinating but completely wrong.

Community bankers have convinced themselves that any new regulatory burden will fall disproportionately on themselves. They are particularly concerned about the consequences of a Consumer Financial Protection Agency (CFPA).

But complexity, disinformation, and ill-treatment of consumers are absolutely not in the interest of community bankers. They mostly engage in simple transparent transactions – the kind that the CFPA would wave through.

How are community bankers helped by consumer rip-offs run by the largest banks? Those schemes undermine consumer purchasing power, destroy confidence, and lead to periodic crises – macroeconomic, regional, and personal. The big banks may renounce such behavior for the future, but anyone in the industry knows that their incentives are quite to the contrary.

But there’s more. The fall-off in consumer spending affects commercial real estate, particularly through its impact on retail space. Community bankers have a major exposure to this sector. This may seem like an indirect mechanism, but the banks know very well what is happening and why.
And that’s not all. The increase in government debt today, taken on as a crisis-fighting measure, means higher taxes for someone tomorrow. Community bankers earn decent incomes and should start putting some of that aside to pay for the misbehavior of big bad banks down the road.

Protecting consumers properly is essential to sustained recovery. It won’t by itself necessarily prevent future crises, but it can limit their impact and their costs. It also tilts the playing field – for once – away from the biggest financial players and towards some of our smaller and better run banks and credit unions.

By Simon Johnson
Who Should Hide Behind the Regulatory Shield?

James Kwak | 04 Aug 2009

This guest post was contributed by Ilya Podolyako, a recent graduate of the Yale Law School, where he was co-chair of the Progressive Law and Economic Policy reading group with James Kwak.

The development of the news coverage of high-frequency trading has been quite interesting. The story started out with a criminal complaint that Goldman Sachs lodged against Sergey Aleynikov, a former employee who allegedly stole some secret computer code from the Goldman network before departing for a new job in Chicago. Incidentally, Mr. Aleynikov appeared to be headed to Teza Technologies, a company recently started by Mikhail Malyshev, who had previously been in charge of high frequency and algorithmic trading at Citadel, a Chicago-based hybrid fund. Immediately after the report leaked, Citadel began investigating Mr. Malyshev’s departure and filed a lawsuit to prevent him from getting his nascent business off the ground. From these facts, some reporters inferred that the surprisingly public maneuvers of two notoriously secretive finance giants vis-à-vis seemingly routine personnel matters showed that Aleynikov had tapped into the gold mine of precious proprietary trading software.

That was two weeks ago. At this point, the story has crescendoed. The New York Times ran a report on high frequency trading. The Economist published a piece on the same topic. Senator Schumer (D-NY) requested that the SEC investigate the matter and the agency acquiesced.

The cynical perspective on these events is that both Schumer’s and Mary Schapiro’s moves with respect to algorithmic trading show that the issue is a red herring. As the argument goes, neither of these actors would touch the practice if it actually underpinned Goldman’s record profits or Citadel’s outstanding performance in 2004-2006. If, however, banning the practice would eliminate a few small hedge funds and create the appearance of revising market frameworks without threatening the big players (a regulatory brush fire of sorts), high-frequency trading would form the perfect political target.

However, I am not that cynical. I am friends with a few traders (yes, I know, I am tainted), and conversations with these guys always prove pretty interesting. At this point, the securities infrastructure is completely dependent on and permeated by high-speed computers carrying out various tasks. Some of these tasks are clearly benevolent
and straightforward – matching buy orders with sell orders, reporting pricing – while others are probably benevolent but too opaque for us to be certain – concealing large orders by splitting them into chunks. Of course, certain practices made possible by advanced technology appear downright abusive.

To reliably distinguish the bad strategies from the good ones, regulators must have a clear idea of whom they work to protect. As the financial rescue has demonstrated, life-saving policies for some entities turn out to be a bullet to the head of others. For this reason, market rules should not be guided by some abstract idea of “fairness.” The concept is alien to trading, and attempts to squeeze it into policy fail quickly because everyone claims that the word means something entirely different. Rather, the SEC and CFTC should seek to remedy specific problems with narrow solutions. If investors of all political orientations can agree that fake prices on public exchanges are a bad thing, the relevant agency should end the practice and move on to the next obvious flaw in the trading process (there is no shortage of these). By contrast, a roving regulator on a mission to end all fraud before it starts will likely overlook actual problem areas in favor of broad banner initiatives that conceal problems instead of solving them. In this sense, regulatory policy should seek to fight actual enemies, not wage infinite war for infinite peace.

What does all of this have to do with high-frequency trading? Well, a longstanding theory of securities regulation divides investors in capital markets into three classes. Passive investors are individuals who use their savings to buy stocks for long-term gain. Passivity here is a virtue, not a sin: regular folks do not have the time to research individual companies in great detail, build their own projections, or actively manage a portfolio. They lack the incentive to do so too, since picking individual stocks is a near-certain way to underperform a diversified portfolio. Thus, the idealized individual investor passively provides capital for functional enterprises throughout the economy and gets a steady annualized return for their services over a long period of time. Moreover, diversified portfolios make passive investors largely indifferent to whether a particular company fails or pushes a competitor out of business, because the increased earnings of the winner in the fight will displace the losses in the investor’s coffers.

Institutional investors like mutual funds form a second group. These enterprises hold large fractions of stock in several companies, either for their own account or on behalf of passive investors. They have the
resources to conduct thorough investigations of various corporations and can push the corporations to improve their business practices by electing their own directors to a set of boards. These moves are impossible for dispersed individuals to carry out because the costs of coordinating and persuading millions of shareholders to do something far outweigh the potential reward from a good decision. Institutional investors, however, immediately profit from good corporate governance because the value of their shares goes up, leading either to capital gain or performance-based fees. In a well-functioning market, institutional investors are responsible for discovering information and maintaining the competitiveness of individual companies. If one institutional investor uncovers key information that other institutional investors lack and acts on it, the less informed institutional investor loses but all diversified, passive investors win. Moves by institutional investors will usually focus on medium- or long-term profit because such bets allow the firm to amortize the significant cost of information discovery.

The third class of investors consists of speculators. These are individuals or companies making a series of short-term bets on a variety of indicators. Speculators are indifferent to whether a particular asset goes up or down, as long as they were correct in predicting the direction of the price change. Speculators rarely uncover significant new information about an asset on their own, because doing so costs a lot and because short-term price changes often depend on substantive information about what will happen to a business or a product far less than they do on what other individuals think will happen to the business or product. In other words, in the realm of speculators, rumors reign supreme. Some of these rumors turn out to be accurate, others turn out to be quite false, but the medium-term pricing of an asset sorts the two out. The role of speculators, on the aggregate, is to provide liquidity and supplement high-quality data held by institutional investors with a stream of additional information that may be worth looking at. Speculative trading activity by itself, however, neither adds nor subtracts value, since rumors (by definition ungrounded in previously known material fact) are equally likely to be true or false, and speculators sit on both sides of the transaction.

Within this framework, market regulators should strive to help each group fulfill its objectives without interfering with the roles of the other group. The government should not try to turn passive investors into speculators or vice versa. Instead, it should seek to prevent speculators from spreading intentionally false information, keep institutional
investors from cornering markets and acting like monopolists, and protect passive investors from blatant theft a la Bernie Madoff.

In this light, high-frequency trading in itself is not the problem. Speculators can and should be able to buy or sell things as often as they like, since the number of times you make a bet on a roll of dice does not change the probability of a six coming up in any given situation. Passive investors, who provides the overwhelming bulk of capital to US markets, should not be hurt by high frequency trading because they should be buying assets at the prevailing ask price in 2009 to sell at the prevailing bid price in 2029. Over this holding period, their profit on the investment will be the same regardless of whether the buy and sell orders are executed by humans in yellow coats running around with paper tickets or extremely advanced machines. Indeed, since people generally cost more to maintain, passive investors should profit from any fancy games that speculators play against each other, provided that the SEC keeps the two camps separate. That is, a well-functioning regulator should explain to the public that the most speculators lose money because of transaction costs and the cost of capital, and that most individuals can get a far better return on their time from reading a novel than by feverishly checking Yahoo! Finance. The last thing we as a society would want is to have the SEC announce that, with the elimination of some algorithms, active trading has become a safe and reasonable activity for working families.

Flash orders, however, are an entirely different beast. By probing the market without the intent to complete a purchase or sale, these transactions erode pricing quality by eating up the distance between the publicly known order price and the limit price, a secret rightfully held only by the investor and his servant, the broker. This pattern of activity means that instead of listing information, providing liquidity, and helping set prices, speculators are actively destroying the ability of a quoted market price to represent the availability of contracts in the market. If I understand the practice correctly, flash orders are nothing more than a simple bait-and-switch fraud enabled by really expensive computers. They should be made as illegal as other forms of lies about financial products.

*By Ilya Podolyako*
This morning, Simon asked why community banks seem to be opposing the Consumer Financial Protection Agency. Felix Salmon agrees that community banks should be in favor of the CFPA, for three reasons: (1) the CFPA should increase the cost of complexity, not the “boring banking” that community banks are typically thought to do; (2) the CFPA should level the playing field with predatory lenders, saving community banks from the choice of losing market share or becoming predatory lenders themselves; and (3) the CFPA should shift competition from finding hidden ways to gouge customers to traditional underwriting, which should be a community bank strength. He later adds (4) the big banks’ big advantage is in deceiving customers, which the CFPA should be able to rein in.

Salmon thinks there are still two reasons why community banks may be afraid of the CFPA:

I think it’s a combination of fear of the unknown, on the one hand, and fear of the big banks, on the other. Since every regulator to date has been successfully captured by Wall Street, it’s reasonable to assume that the CFPA might end up being captured by Wall Street too. In which case the burdens of the CFPA might end up being borne disproportionately by smaller community banks.

The commenters on Simon’s post made some similar points, beginning with Bond Girl – “I know several executives at small banks that were flipping subprime mortgages and the like” – and Russ – “it’s not irrational for the smaller banks to fear that in practice regulation would be gamed to further empower the big banks while falling on the backs of the smaller.”

I think it breaks down this way. To the extent that community banks were ripping off customers with mortgages they had no chance of repaying (if Richard Posner or Peter Wallison is reading this, replace everything from “ripping” to “repaying” with “helpfully giving customers the option of rationally speculating on housing prices”), then that is something that should stop, and the CFPA should be aimed against them. Put another way, if that is the case, then community banks
should be ignored on this issue just like Angelo Mozilo should be ignored.

That said, I think there are probably many community banks that do fit the “boring banking” stereotype. When I bought my family’s house, I got a mortgage from Greenfield Savings Bank, based in Greenfield, Massachusetts, which, I believe, did not even reserve the right to resell my mortgage. Looking at their current rate sheet, I see that they offer 15-, 20-, and 30-year fixed-rate mortgages; a 5/1 adjustable-rate mortgage; and 30- and 40-year fixed-rate mortgages for first-time homebuyers. And that’s it.

The first question to ask about these banks is: if size is so important in banking (I’m thinking of all those people who say that breaking up mega-banks would hurt consumers or, worse, the entire country), then why does Greenfield Savings even exist? Community banks must have some source of competitive advantage over Bank of America and Citigroup. There are two obvious possibilities. One is that customers prefer dealing with local banks, and based on my personal experiences, the level of customer service is far superior than what you get with a megabank. The other is that community banks, as Salmon said, are better at underwriting, because they actually know the characteristics of the neighborhoods they are underwriting in and, possibly, the borrowers they are underwriting. The reason I went with Greenfield Savings was that they offered me a lower rate than any national bank, and presumably they were able to do this because they knew something about the local market that the national banks didn’t.

Now, both of these are advantages that should be protected by the CFPAs. That is, if your goal is to provide better customer service, you are probably not in the business of screwing your customers. And if your competitive advantage is in underwriting, then you have no need to confuse customers with unnecessarily complex products. You should be happy that Elizabeth Warren is keeping predatory lenders out of your backyard, because even if you refuse to match their mortgages, they are driving up housing prices and making it harder for you to find qualified borrowers.

(On the other hand, if you decide that your strategy is to originate toxic mortgages and flip them to investment banks, then you have no competitive advantage left and no business to go back to when demand for your mortgages craters, and no one will bail you out because you are too small.)
So we are left with Russ’s problem: small banks believe that once the CFPA is created, it will be captured by big banks, who will use it to screw them – not an irrational fear, given the way regulation is often used as a stick with which one set of corporate interests beats on another. But the simple answer there is that Tim Geithner and Michael Barr (and Barney Frank) need to design the CFPA in such a way as to minimize this possibility. Maybe they could have rules requiring the CFPA to allocate auditing resources in some proportion to firms’ size. Maybe they could slap special anti-lobbying provisions on the CFPA (high salaries but no ability to work for a company you regulated for a long time) to reduce the risk of capture. Maybe they could put in a tax-and-transfer mechanism to ease the compliance costs for small banks. Maybe something else.

The bottom line is, either community banks are just as guilty as the unregulated mortgage brokers and the investment banks that funded them, in which case Geithner et al. need to make the case that Congress should not listen to them; or community banks are part of the solution, in which case Geithner et al. need to make the case to them that they should support the CFPA. I obviously support what Geithner is trying to achieve with the CFPA. But it’s time to close the deal.

_By James Kwak_
The Republican Consumer Financial Protection Plan

James Kwak | 05 Aug 2009

Last week, Simon criticized Jeb Hensarling’s article on the Republican approach to consumer financial protection, saying “the only tools they propose are those that have been tried and failed, repeatedly, in the recent past.” However, Simon couldn’t get a copy of the Republican plan at the time, so he asked for help. Sean West of the Eurasia Group helpfully tracked down the latest copies of the documents, which were in the public domain: section-by-section summary; draft bill.

And … there’s nothing there.

Here’s the summary version of the relevant section (Title 3, Section 311):

Creates an Office of Consumer Protection within the [Financial Institutions Regulator]. The Office of Consumer protection is responsible for all consumer protection rulemaking under the Consumer Credit Protection Act, and will coordinate with the other divisions of the FIR in enforcing consumer protection. Establishes a consumer complaint hotline for the timely referral and remedy of consumer complaints, regardless of charter type or regulatory structure. Requires the Office of Consumer Protection to use extensive consumer testing prior to the promulgation of new consumer protections. Requires a comprehensive review of consumer protection rules and regulations on a regular basis with reports to be issued to Congress based on inaction or action with regards to consumer protection standards.

Basically we get a hotline, a requirement that regulations have to be extensively tested, and periodic review.

Reading the draft bill, things get even weaker. 311(c) says rules of the Office of Consumer Protection (OCP) have to be approved by the board of directors of the Financial Institutions Regulator (FIR) – read John Dugan, Sheila Bair, etc. 311(e) mandates reviews, every seven (!) years, of disclosures … by the FIR itself. 311(g) requires, every seven years, a cost-benefit analysis of all consumer protection regulations to determine “if such regulation should remain the same or if such regulation should be revised.”
Cost-benefit analysis sounds good, but as I’ve previously written, this can have perverse effects when the costs are easily quantifiable but the benefits are difficult to quantify in monetary terms. A classic example is health – valuing the feeling of good health is notoriously difficult, although there are methodologies for it. Another classic example is tail risk, where you have to estimate the small probability of a very bad thing happening. Sound familiar?

Note also that the emphasis is on periodically pruning back regulation, rather than creating new regulations for new products and practices. In short, the effect if any of this plan would be to weaken consumer protection.

Now, this is not particularly surprising, nor is it particularly egregious behavior. The Republicans have zero chance of passing any bill that they author (although, for a party with forty senators, they have a surprising amount of influence on the Senate Finance Committee), so they are under no obligation to put forward responsible proposals to address real problems. And no one expects them to waste their time working on such proposals. But after Simon’s previous post, I thought we owed it to them to look at their “plan.”

By James Kwak
As every major economics blog has already reported, Brad Setser is walking away from his blog to work for the National Economic Council. Setser’s blog was one of the best at actually providing original information and analysis (data, even) you couldn’t get anyplace else; the only other competitor in that category that springs to mind is Econbrowser. It was the first place I looked when I had a question about the trade deficit, the Chinese-American economic relationship, or foreign currency reserves. We’ll all be worse off as bloggers, hopefully better off as citizens of the United States.

By James Kwak
In a quote potentially for the ages, John C. Dugan, Comptroller of the Currency since 2005, told the Senate Banking Committee yesterday, enforcement of consumer protection laws “should stay with the bank regulators, where it works well.”

This is a bold statement. Does Mr. Dugan have any evidence to support the idea that consumer protection vis-à-vis financial products currently works well? A close reading of his written testimony to the Senate Banking committee reveals none.

In fact, his whole testimony sounds like it comes from a parallel universe – one that did not just experience the biggest banking crisis in world history.

On p.18 of his testimony, he does have a good statement of the broader issues (emphasis added).

“Today’s severe consumer credit problems can be traced to the multi-year policy of easy money and easy credit that led to an asset bubble, with too many people getting loans that could not be repaid when the bubble burst. With respect to these loans – especially mortgages – the core problem was lax underwriting that relied too heavily on rising house prices. Inadequate consumer protections – such as inadequate and ineffective disclosures – contributed to this problem, because in many cases consumers did not understand the significant risks of complex loans that had seductively low initial monthly payments. Both aspects of the problem – lax underwriting and inadequate consumer protections – were especially acute in loans made by nonbank lenders that were not subject to federal regulation.”

The “especially acute” in the last sentence may be correct, but we know that many regulated banks (covered by all the existing regulators) participated in exactly the same rip-offs of consumers – which created the basis for a financial system meltdown.

Remember that the OCC supervises over 1,500 national banks, which includes many that have run into serious difficulties recently (a full list is not easy to find, but start here and here; or use this search; the list includes Citi, BoA, Wells Fargo, etc). (Post here stories of how OCC-supervised banks either took care of you as a consumer or mistreated you. Did the OCC side with you or the bank?)
The heart of Mr. Dugan’s objection to the Consumer Financial Protection Agency (CFPA) as proposed appears on p.25,

“The Proposal would vest all consumer protection rulewriting authority in the CFPA, which in turn would not be constrained in any meaningful way by safety and soundness concerns. That presents serious issues because, in critical aspects of bank supervision, such as underwriting standards, consumer protection cannot be separated from safety and soundness.”

Mr. Dugan wants to put the bank first – and if that involves taking more from the consumer or even taking advantage of the consumer, so be it (read the first full paragraph on p.26 carefully).

My favorite statement comes at the end.

“Our experience at the OCC has been that effective, integrated safety and soundness and compliance supervision grows from the detailed, core knowledge that our examiners develop and maintain about each bank’s organizational structure, culture, business lines, products, services, customer base, and level of risk; this knowledge and expertise is cultivated through regular on-site examinations and contact with our community banks, and close, day-to-day focus on the activities of larger banks.”

Is this why almost all our major banks essentially failed in 2008?

*By Simon Johnson*
My Dog, and Your Next Dog

James Kwak  | 05 Aug 2009

Economics bloggers have their side interests. Felix Salmon has cycling. Tyler Cowen has restaurants. Yves Smith has cute pictures of animals (see the “antidote du jour” in any Links post). Mine is dogs.

My dog died on Wednesday last week at the age of sixteen. We loved him like a child, which I know to be true now that I have a child. He made me a better, happier, more generous person.

My wife and I adopted Dauber at the age of eight, after his first family gave him up because they didn’t have time for him. He was what you would call “hard to place” – besides being relatively old, he barked a lot, hated other dogs, and didn’t particularly like people. He also had many medical problems, beginning with bladder stones and damaged vertebrae (when we got him) through pancreatitis and congestive heart disease. I think it’s highly likely that if we hadn’t adopted him he would have been euthanized eight years ago.

But the lesson, and the reason for this post, is that Dauber gave us as much joy as any being could have given us. So the next time you are looking for a dog (or other animal companion), please visit an animal shelter and see if you could adopt a dog who has been given up and needs a home, rather than going to a breeder and increasing demand for puppies when so many dogs already need families. And please consider adopting a dog who is hard to place, maybe one who is getting on in years and isn’t as cute as a newborn puppy.

In our area, we like and are making a donation to the Dakin Pioneer Valley Humane Society. There are also various sanctuaries and shelters throughout the country for animals who have trouble finding families, but I don’t know any well enough to recommend them; you could contact the Humane Society of the United States and ask if they have suggestions.

Thanks for reading.

By James Kwak
Right now, it appears that the biggest barrier to health care reform is people who think that it will hurt them. According to a New York Times poll, “69 percent of respondents in the poll said they were concerned that the quality of their own care would decline if the government created a program that covers everyone.” Since most Americans currently have health insurance, they see reform as a poverty program – something that helps poor people and hurts them. If that’s what you think, then this post is for you.

You do not have health insurance. Let me repeat that. You do not have health insurance. (Unless you are over 65, in which case you do have health insurance. I’ll come back to that later.)

The point of insurance is to protect you against unlikely but damaging events. You are generally happy to pay premiums in all the years that nothing goes wrong (your house doesn’t burn down), because in exchange your insurer promises to be there in the one year that things do go wrong (your house burns down). That’s why, when shopping for insurance, you are supposed to look for a company that is financially sound – so they will be there when you need them.

If, like most people, your health coverage is through your employer or your spouse’s employer, that is not what you have. At some point in the future, you will get sick and need expensive health care. What are some of the things that could happen between now and then?

- Your company could drop its health plan. According to the U.S. Census Bureau (see Table HIA-1), the percentage of the population covered by employer-based health insurance has fallen every year since 2000, from 64.2% to 59.3%.*
- You could lose your job. I don’t think I need to tell anyone what the unemployment rate is these days.**
- You could voluntarily leave your job, for example because you have to move to take care of an elderly relative.
- You could get divorced from the spouse you depend on for health coverage.

For all of these reasons, you can’t count on your health insurer being there when you need it. That’s not insurance; that’s employer-subsidized health care for the duration of your employment.
Once you lose your employer-based coverage, for whatever reason, you’re in the individual market, where, you may be surprised to find, you have no right to affordable health insurance. An insurer can refuse to insure you or can charge you a premium you can’t afford because of your medical history. That’s the way a free market works: an insurer would be crazy to charge you less than the expected cost of your medical care (unless they can make it up on their healthy customers, which they can’t in the individual market).

In honor of the financial crisis, let’s also point out that all of these risks are correlated: being sick increases your chances of losing your job (and, probably, getting divorced); losing your job reduces your ability to afford health insurance, either through COBRA or in the individual market; if your employer drops its health plan, that’s either because health care is getting more expensive (meaning harder for you to afford individually) or the economy is in bad shape (making it harder for you to get a job that does offer health coverage).

In addition, there is the problem that even if you are nominally covered when you do get sick, your insurer could rescind your policy, or you may find out, as Karen Tumulty’s brother did, that your insurance doesn’t cover the treatment you need. But while important, this is a second-order problem. The first-order problem is that as long as your health insurance depends on your job, your health is only insured insofar as your job is insured – and your job isn’t insured.

The basic solution is very simple. In Paul Krugman’s words: “regulation of insurers, so that they can’t cherry-pick only the healthy, and subsidies, so that all Americans can afford insurance.” I know that there are lots of details that consume people who know health care better than I do, and I know those details are important. But as an individual who is worried about his or her own health insurance (and that is the point of this post), that’s what you want. You want to know that if you lose your job, you won’t be shut out because you’re too sick,*** and you won’t be shut out because you’re too poor.

But we won’t get there as long as people remain convinced that health care reform is for poor people. It’s for everyone – everyone, that is, who isn’t independently wealthy or over the age of 65. Because all of us could lose our jobs. (Have I repeated that point enough?)

Now, I admit that if you are over 65, health care reform is not for you, because you are in the one group in our society that enjoys true health insurance – insurance that you cannot lose, that is paid for by taxes, and
that is effectively guaranteed by the government. So maybe there’s nothing in it for you, except perhaps an improvement to the prescription drug component of Medicare. But I cannot believe that, as the only people who have reliable health insurance, you would oppose health care reform that would provide reliable insurance for the rest of us.

* This doesn’t necessarily mean that all those people lost employer-based health coverage because their employers dropped their plans; some of it could be that the employee contributions were increased to the point where they couldn’t afford it anymore. 1.1 percentage points of the shift is due to people becoming eligible for Medicare or military health plans.

** If you lose your job, or you get divorced from a spouse through whom you get health coverage, you are eligible for continued coverage under COBRA. However: (a) this only necessarily applies if your employer has 20 or more employees; (b) you have to pay the full, unsubsidized cost of your health plan, which can be particularly difficult after losing your job; and (c) it only lasts for eighteen months.

*** I said earlier that insurers can’t charge premiums that are less than the expected cost of your care unless they can make it up on the healthy customers, and they can’t in the individual market. But if all insurers are prohibited from doing medical underwriting (pricing based on healthiness), then they will all have to overcharge the healthy customers, and the system could work. This is still a tricky issue – and single-payer (like Medicare) would be much simpler – but it can be made to work even in a competitive market.

Update: A couple of small things. and one big thing:

First, I called rescission a “second-order” problem, which was probably surprising, given that my post on it got over 100,000 page views (thanks to the Huffington Post). I meant “second-order” not to mean that it isn’t important, but that it is logically subsequent to the question of whether you have health insurance in the first place, and this post is about whether you can count on having health insurance in the first place.

Second, J.D. points out in the comments that there is a problem with COBRA I didn’t mention: If you relocate to an area where your employer doesn’t have a plan, then you can’t count on it at all.

Third, a few people said that it was the fault of the administration (or the Democrats generally) that health care reform is framed as a “poverty program.” There’s something to that point, but I don’t think it’s quite
right (and I didn’t put it right in the first paragraph above). I think it is a poverty program – but the vast majority of us are, actually, poor. The combination of job loss and serious illness could wipe out almost anyone (under the age of 65 – actually, anyone over 65 as well, since Medicare doesn’t cover extended nursing home care), and we all suffer serious economic insecurity because of it. The political problem is that the median American doesn’t identify as poor (although he probably thinks he needs more money) and thinks that poverty programs are for “other people.” I think that middle-class and upper-class people should support poverty programs for other people, but that’s an unnecessary discussion. My point here is that the vast majority of us are poor, when it comes to health care, and therefore we should get behind reform out of self-interest.

_by James Kwak_
Larry Summers, Economic Recovery, And Ben Bernanke

Simon Johnson  | 06 Aug 2009

In a memo to Congress on Tuesday, Larry Summers – the head of the White House National Economic Council – laid out his view of where we are and what is likely to happen next in our economic recovery.

His tone was more upbeat than we’ve heard in recent utterances, although he has been heading in this direction for a while – contrast this April speech with this appearance in July.

What is beginning to turn the economy around? Summers claims great effects from the fiscal stimulus Recovery Act, but much of that money has not yet been spent.

He also puts weight on “an aggressive effort to tackle the foreclosure crisis.” There have been sensible steps in that direction, but so far the effects have been decidedly modest.

The main explanation has to be that the administration prevented the financial system from collapsing. In an economy as large and diverse as that of the United States – with much more government spending than at the time of the Great Depression – as long as the entire provision of credit does not disintegrate, we will recover.

Summers refers to “A Financial Stabilization Plan”, but this is ex post grandiosity. In fact, the government simply demonstrated unflinching support for all big financial firms as currently constituted. We the taxpayer effectively guaranteed all these firms debts, unconditionally. Once the market figured out that the Treasury, Federal Reserve and other officials could pull this off, the panic was over.

But this victory brings also real danger.

Rahm Emanuel, the White House Chief of Staff, put it well recently, “The [finance] industry is already back to their pre-meltdown bonuses. We need to make sure we don’t slip back to risky behavior where the institutions have all the upside and the taxpayers have all the downside, which is why we need regulatory reform.”

Summers does not shy from this issue. In his letter to Congress he says we need, “Comprehensive reform of the nation’s financial regulatory system so that a crisis like this never happens again,” and “Financial regulatory reform is vital to preventing against (sic) the asset market bubbles that have characterized previous recoveries.”

There are, however, three problems with what he proposes.
First, he says that the administration “has unveiled a sweeping set of regulatory reforms.” But the reality is more modest. There will be some slight strengthening of capital requirements, somewhat more attention paid to “systemic risk” (although this is not well defined), and mildly tougher regulation of derivatives. Most of this amounts to essentially business as usual.

Second, to the extent that the administration does have a few good ideas – for example on a new consumer protection agency for financial products – it has let opposition build to the point where the lobbyists may well be able to prevent progress. The time to push for change was earlier this year, when banking was still in political disarray; now the sector is stronger than even on Capitol Hill.

Third, the administration can’t even bring its own regulatory agencies along with its modest reforms. Last week, Treasury Secretary Tim Geithner expressed extreme frustration with the efforts of these agencies to block reform. This week, appearing before the Senate Banking Committee, the same people were still in serious blocking mode.

Even the Federal Reserve chairman, Ben Bernanke, does not seem to be on board with reform as proposed by Geithner and pushed by the White House. It’s not clear if Bernanke has become too close to the banking industry or too captured by his staff, but in any case Treasury feels that he is not fully on board.

If the administration really wants to put the economy on a path to sustainable bubble-free growth, it looks increasingly likely that it will want to replace Bernanke when his term is up early next year.

Secretary Geithner is the most plausible replacement. He was previously head of the New York Fed and vice chair of the Federal Open Market Committee, so he knows the system intimately. He has spearheaded all the financial rescue efforts of the past few years; better than anyone he knows what went wrong. The markets see him as a safe and friendly pair of hands.

And, increasingly, if he wants any kind of real reform, it looks like Secretary Geithner will have to go to the Fed and implement it himself.

By Simon Johnson

This post originally appeared on the NYT.com’s Economix blog and is reproduced here with permission. The usual fair use rules apply to short quotations, but if you wish to reproduce the entire post, please contact the New York Times.
For more on why I’m taking the side of Secretary Geithner against the regulators, see my conversation with Ben Eisler of The New Republic.
How To Blow A Bubble

Simon Johnson | 07 Aug 2009

Matt Taibbi has rightly directed our attention towards the talent, organization, and power that together produce damaging (for us) yet profitable (for a few) bubbles. Most of Taibbi’s best points are about market microstructure – not the technological variety usually studied in mainstream finance, but more the politics of how you construct a multi-billion dollar opportunity so that you can get in, pull others after you, and then get out before it all collapses. (This is also, by the way, how things work in Pakistan.)

In addition, of course, all good bubble-blowing needs ideology. Someone needs to persuade policymakers and the investing public that we are looking at a change in fundamentals, rather than an unsustainable and dangerous surge in the price of some assets.

It used to be that the Federal Reserve was the bubble-maker-in-chief. In the Big Housing Boom/Bust, Alan Greenspan was ably assisted by Ben Bernanke – culminating in the latter’s argument to cut interest rates to zero in August 2003 and to state that interest rates would be held low for “a considerable period”. (David Wessel’s new book is very good on this period and the Bernanke-Greenspan relationship.)

Now it seems the ideological initiative may be shifting towards Goldman Sachs.

As Bloomberg reported on August 5th, “Goldman economists, led by Jan Hatzius in New York, now see a 3 percent increase in gross domestic product at an annual rate in the last six months of this year, versus a previous estimate of 1 percent. The new projections were included in a research note e-mailed to clients.”

Goldman’s public thinking, of course, has been that we face such slow growth that interest rates should be kept low indefinitely. There is, in their view, no risk of inflation – and no such thing as potentially new bubbles (e.g., in emerging markets). The adjustment process will go well, as long as monetary policy stays very loose – it’s back to Bernanke’s 2003 line of thinking.

This line of reasoning has been very influential – reinforcing Bernanke’s commitment not to tighten monetary policy in the foreseeable future and fitting in very much with the Summers model of crisis recovery. Just a couple of weeks ago, in his July 14 report, Jan Hatzius argued, “further stimulus remains appropriate” and “the
appropriate debate is not whether fiscal and monetary expansion is appropriate in principle but whether it has been sufficiently aggressive.” I don’t know if he has revised this line in the light of the big upward revision in his growth forecast or whether he is still saying, “Ultimately, we do expect further stimulus, but it may take significant disappointments in the economic data and the financial markets before policymakers move further in this direction.”

Much faster growth than expected is, of course, in today’s context a good thing. But it also brings complications. If you keep monetary policy this loose for much longer, you will feed bubbles. And if you encourage even looser monetary and fiscal policy, there will be a costly reckoning not too far down the road.

Monetary policy orthodoxy under Greenspan did not care about bubbles in the least. Now we (led by Greenspan) have massively damaged our financial system, our real economy, and our job prospects, this view is under revision.

Of course, in principle you should tighten regulation around lending but, just like 2003-2007, who is really going to do that: the US, China, the G20? On this point, all our economic leadership is letting us down – although they are getting a powerful assist from people like Goldman (and Citi and JP Morgan and almost everyone else on Wall Street.)

Next time, our big banks will take another massive hit – quite possibly bigger than what we saw in 2008. Goldman and its insiders are ready for this. Are you?

*By Simon Johnson*
The Problem That Won’t Go Away

James Kwak  | 07 Aug 2009

With everyone hoping for positive GDP growth in Q3 and Goldman Sachs analyst Jan Hatzius now predicting growth at an annual rate of three percent in the second half of the year, the banks, investors, and politicians are all hoping that that nasty problem of foreclosures would just go away already. Unfortunately for everyone – especially the people losing their houses – there’s no reason for it to go away.

Unemployment is always a lagging indicator, and given the record low number of average hours worked, it will turn around especially slowly this time. Until then, people will continue to lose their jobs and wages will remain flat, and any small rebound in housing prices is unlikely to help more than a few people refinance their way out of unaffordable mortgages. So unless the other part of the equation – monthly payments – changes, the number of foreclosures should just continue to rise.

Calculated Risk provides this great chart from Matt Padilla (see the CR post for definitions of the categories):

The foreclosure problem has gotten a little more press recently as the Treasury Department attempts to follow through on its “name and shame” campaign to pressure mortgage servicers to modify more loans.

There seem to be two main explanations for why more loans are not being modified. The New York Times recently reported that for the servicers at the center of the process, it is simply more profitable to make fees off of delinquent loans than to foreclose on them and give up that stream of fees. On this theory, the cash incentives being provided by the government are simply not big enough to change their financial incentives.

The servicers prefer to argue that their hands are tied by the investors who own the mortgage-backed securities that have swallowed up the mortgages. On this theory, the Pooling and Servicing Agreements that govern these securitization trusts restrict the ability of servicers to modify mortgages. However, an article by Karen Weise in ProPublica yesterday casts serious doubt on this claim. Weise follows a household that is trying to get a modification of their mortgage, serviced by Wells Fargo, under the Making Home Affordable plan. Wells Fargo claims that it cannot modify the mortgage under those terms because “the investors
need their money,” and instead proposed a different modification, which would increase the loan principal by $80,000. However:

researchers at UC Berkeley’s law school looked at the contracts covering three-quarters of the subprime loans that were securitized in 2006. The researchers found that only 8 percent prohibited modifications outright. About a third of the loans were in contracts that said nothing about modification, and the rest set some limits but generally gave the servicers a lot to leeway to modify, particularly for homeowners that had defaulted or would likely default soon.

And that is the case with the loan in question, for which the servicer need only make a “reasonable and prudent determination” that the modification is in the investors’ interests. What’s more, in this case, “Deutsche Bank [trustee for the securitization trust] spokesman John Gallagher said servicers are ‘solely responsible’ for deciding all modifications.”

According to Weise’s article, the administration anticipated servicers’ fear of being sued by investors, but a key phrase in the proposed legislation was removed by Congress as a result of lobbying efforts. Servicers would probably have preferred the phrase be left in, but the end result is it gives them a convenient excuse for failing to modify mortgages – which, as the Times pointed out, is often in their own financial interests.

It will be interesting to see if the administration chooses to take serious action to reduce foreclosures, or whether it sticks to a “name and shame” strategy that is likely to be ineffective.

By James Kwak
Filling the Financial Regulatory Void

James Kwak | 08 Aug 2009

This guest post was contributed by Bond Girl, a frequent commenter on this site and author of The Bond Tangent, a very good blog on the esoteric but important world of municipal bonds. I invited her to write it after reading her comments on the topic of financial regulation on this post.

In June, the Obama administration released a report outlining various financial regulatory reforms. The proposed reforms are intended to meet five objectives, essentially: (1) to eliminate regulators’ tunnel vision; (2) to regulate certain financial products and market participants that have so far evaded supervision; (3) to protect consumers from unfair and deceptive sales practices; (4) to provide a framework for responding to financial crises and the failure of major financial institutions; and (5) to promote these efforts globally. Much of the subsequent policy debate has been focused on whether or not the reforms detailed in the report address these objectives. This is a political triumph for the administration because it distracts from the report’s one glaring omission – how to address a culture of sustained affinity between the supervisors and the supervised.

The administration’s proposal appears to portray the financial crisis as nothing more than an accident of reasoning. Because financial regulation in our country evolved in a fragmented manner, regulators’ perceptions of risk were determined by their respective niches when a holistic understanding of risk was required to predict a market failure of this magnitude. It logically follows then that the administration’s preference would be to create a meta-regulator (in this case, by extending the powers of the Federal Reserve and establishing an advisory council) to oversee the supervisory project as a whole and seek out system-wide threats.

While I am sure no one would dispute that a holistic understanding of risk is required to assess financial stability, an even more basic condition of effective regulation is that regulators are motivated to provide honest information about the institutions they supervise. I am not inclined toward conspiracy theories and I obviously do not buy into the caricature of industry players sold by the mainstream media. That said, it is clear that there is a large degree of regulatory capture going on in the financial sector, either directly though professional incest or indirectly through shared intellectual sympathies, which some players
have been able to exploit to such an extent that it has reduced standards for the entire industry. It is also clear that this is hardly a novel development.

Financial institutions did not amass trillions of dollars of toxic assets and tangle themselves up in a destructive web of credit derivatives by accident. Financial institutions did not produce and maintain technology allowing them to take advantage of traditional investors by accident. A thief was not able to operate a multi-billion-dollar Ponzi scheme for decades by accident. We are not talking about the occasional rogue trader here who has bribed his compliance officer. Even within the existing regulatory architecture, these activities required a considerable amount of complacency (to be polite) by financial regulators across agencies, over the course of many years, and through many cycles of political appointees from both parties.

I would argue that the fundamental flaw in financial regulation is that it is based on the assumption that regulators are not self-interested individuals like the rest of us. We think about regulation only in terms of how to engineer the incentives of the regulated and ignore the fact that regulators themselves rarely have a stake in doing their job well, which in any other occupation would limit the motivation and types of individuals a position attracts. We all know how the performance of a consistently good trader is rewarded. How is the behavior of a consistently good regulator rewarded?

On the other hand, it is not difficult to see what incentives regulators have to adopt a collaborative posture with the industry (again, to be polite), especially within the organization in which the administration wants to concentrate regulatory responsibilities. The presidents of the Federal Reserve Bank of New York generally come from or end up at investment banks. So many Goldman Sachs employees have held positions in the Treasury and Fed banks in their careers it is a cliché.

Even beyond this, there is probably some value transferred just through the association or intellectual sympathy with industry-types (what Jon Hanson would refer to as “deep capture”) that results in regulators having a bias they do not recognize. If one revisits what Fed officials were saying about financial innovation leading up to the crisis, it is not difficult to see that (1) they thought they were thinking holistically about the risks financial innovation posed, and (2) they were not being intellectually honest in the information they presented about the industry. Even the more prescient regulators figured innovation was a
good thing at the time. As a rule, supervisors were disposed to explain away risk by market discipline because they believed themselves to belong to a club of people with special, sophisticated knowledge of the markets, and this is something they value. From the perspective of some in the financial industry, it is something that can be traded.

Sheila Bair’s argument in the regulatory turf war spectacle that is underway would be that these examples illustrate the risk of concentrating supervisory responsibilities in one entity. But it is not a matter of luck whether we get a regulator that is more or less swayable by the industry. By virtue of regulators’ incentives, the financial industry is basically self-regulated.

It is unlikely that consumers will ever hold much influence over the realities of the financial regulatory process because they are not organized in comparison to the financial industry, which concentrates significant resources in the creation of inefficient regulators. By and large, consumers are not well-informed about what they have at stake in the regulatory process and, even if they were, that would not be the sole determinant of how they define themselves politically.

Adding another layer of guards to guard the existing guards ultimately results in an infinite regress. I do not think it is cynical to suggest that, absent an actual paradigm shift with respect to accountability in the financial industry, we are just going to have more of the rent-seeking that has gone on to date and the economic calamities that ensue. For my part, I would propose opening up financial regulation to a small group of social entrepreneurs. Let people establish for-profit companies that can compete for government contracts to stress test the holdings of financial institutions independently and audit their records.

These contracts can be funded by fees charged to the industry that pass through the federal budget and are subject to public scrutiny. Although the fee income that supports these entrepreneurs would derive from industry operations, the social entrepreneurs will not have the power to establish the fees themselves, which should reduce the “shopping” behavior that already exists in financial regulation and with the rating agencies. Some degree of slack will develop as with any form of delegation, but that may be reduced to some extent by adding performance-based metrics to the terms of contracts or by giving the companies a portion of recoveries when they identify instances of fraudulent behavior (similar to what the Internal Revenue Service does with its whistleblower program). Even if social entrepreneurs pull their
employees from the same pool of talent as the financial institutions they inspect, the opportunity to profit should make them less sympathetic to industry interests and encourage them to invest in furthering their expertise.

I would hope this is something most people in the financial industry would support. It would be an opportunity to show the industry still cares about actual capitalism.

*By Bond Girl*
What Do the People Want?

James Kwak | 09 Aug 2009

To the *New York Times’s* credit, they asked them. And this is what they found (from the beginning of the article, entitled “New Poll Finds Growing Unease on Health Plan”):

President Obama’s ability to shape the debate on health care appears to be eroding as opponents aggressively portray his overhaul plan as a government takeover that could limit Americans’ ability to choose their doctors and course of treatment, according to the latest New York Times/CBS News poll.

Americans are concerned that revamping the health care system would reduce the quality of their care, increase their out-of-pocket health costs and tax bills, and limit their options in choosing doctors, treatments and tests, the poll found. The percentage who describe health care costs as a serious threat to the American economy — a central argument made by Mr. Obama — has dropped over the past month.

The article does cite several statistics from the poll, and does show several signs that are favorable to President Obama, including that the public overwhelmingly favors him over the Republicans when it comes to health care, and overwhelmingly thinks that he is trying to work with Republicans more than the converse. But the overall impression you get is that Americans are afraid of health care reform.

But are they?

Here are some of the raw numbers:

- The government should guarantee health insurance for all Americans, by 55-38.
- The government should “offer[] everyone a government administered health insurance plan,” by 66-27.
- Insurers should have to cover anyone regardless of medical history, by 76-19.
- It is true that 68% of people think that health care reform could limit their access to treatment; but 66% are concerned that without reform, they could lose coverage at some point.
Similarly, 76% think that health care reform could increase their taxes; but 75% think that without reform, the cost of their health care will go up.

It seems to me that on the most important issues, America is solidly behind the House versions of health care reform.

But although Americans favor health care reform, by 59-31 they think the current bill will not benefit them personally – presumably, as I’ve argued before, because they are under the probably-mistaken assumption that they currently have good coverage and will not lose it. Now, this does not necessarily mean they would not favor the bill. As Ezra Klein wrote a while back, the administration could have made the argument for reform in moral terms – society has a moral obligation to provide basic health care to all people, and if it costs the better-off among us a few bucks, then that’s the price we should pay. But instead, it went for technocratic arguments instead – we have to “bend the curve” of health care costs. (In 2007, people thought that universal coverage was more important than reducing health care costs by 65-31; after months of being told by both sides that it is costs that matter, universal coverage still wins by 53-43.)

So at this point, I think the key message has to be that health care reform is good for everyone (at least everyone under 65; those over 65 already enjoy the benefits of reform), because it protects you against the risk of losing your job and getting sick.

By James Kwak
Credit Conditions In The Absence Of Consumer Protection

Simon Johnson  | 10 Aug 2009

Even some of our most sophisticated commentators doubt a link between consumer protection and any macroeconomic outcomes. Consumer protection, in this view, is microeconomics and quite different from macroeconomic issues (such as the speed and nature of our economic recovery).

Officially measured interest rates are down from their height in the Great Panic of 2008-09 and the financial markets, broadly defined, continue to stabilize. But are retail credit conditions, i.e., the terms on which you can borrow, getting easier or tougher?

On credit cards, there’s no question: it’s getting more expensive to borrow, particularly because new fees and charge are appearing. Of course, lenders have the right to alter the terms on which they provide credit. We could just note that this tightening of credit does not help the recovery and flies in the face of everything the Fed is trying to do – although it fits with Treasury’s broader strategy of allowing banks to recapitalize themselves at the expense of customers.

But there is an additional question: will these changes in lending conditions be reflected in the disclosed Annual Percentage Rate (APR)? Historically, the rules around the APR – overseen by the Federal Reserve - have not forced lenders to include all charges in this calculation. Why is this OK?

It’s not OK. This would be like cereal manufacturers including only some ingredients on their labels. Or makers of children’s toys not telling you that some dangerous chemicals are involved.

Why has this been allowed to happen? Essentially, because nobody watches out for the consumer of financial products. Our regulation of financial institutions is byzantine and completely out of date; our banks game the system with impunity (e.g., nationally chartered banks are not subject to state usury laws; see this BusinessWeek article, section on payday loans).

Historically, the most powerful overseers of the system thought that this kind of detail didn’t matter – or that any changes in what banks did were a form of “financial innovation” that must naturally benefit everyone. But this is exactly the attitude that brought us to subprime, Alt-A, and other “exotic” (i.e., misleading rip-off) mortgages.
And it is, sadly, the attitude among existing regulators that still predominates today. This implicit attitude towards consumers is in no way helpful, if we want an economic recovery, jobs, and a reasonably stable growth going forward. But it’s what we appear to be stuck with.

Our financial regulatory system is a disaster. The Obama administration should have called it by its proper name, proposed to close it down entirely, and argued to replace it with a more integrated and completely rationalized approach. That at least would have moved the bargaining position of the regulators – they would now be too busy trying to save their jobs to oppose Treasury on substance.

If you think I am wrongdoing credit card companies, lenders, or regulators in any way, post details below. And if any representative of these institutions or their associated lobby groups is willing to debate these issues in public, just give me a call.

By Simon Johnson
The usual concern about the US-China balance of economic and political power is couched in terms of our relative international payments positions. We’ve run a large current account deficit in recent years (imports above exports); they still have – by some measures – the largest current account surplus (exports above imports) even seen in a major country. They accumulate foreign assets, i.e., claims on other countries, such as the US. We issue a great deal of debt that is bought by foreigners, including China.

There are some legitimate concerns in this framing of the problem - no country can increase its net foreign debt (relative to GDP) indefinitely without facing consequences. And the Obama administration, ever since the Geithner-Clinton flipflop on China’s exchange rate policy early in 2009, seems quite captivated by this way of thinking: Will they buy our debt? Can we control our budget deficit? What happens if China dumps its dollars?

The reason real to worry about China, however, has very little to do with external balances, China’s dollar holdings, or even capital flows. It’s about productivity and rent-seeking.

China mostly invests in activities that raise productivity, raising the amount of goods and services that they can produce. This could be manufacturing or infrastructure or various kinds of services. Agriculture lags but continues to get some new investment. And of course they pour money into education.

I’m not a fan of the Chinese way of organizing their economy or their society. They no doubt have weaknesses that will catch up with them eventually (including waves of overinvestment in some sectors), and there’s good reason to think they will be the center of a big new “Asia Century” Bubble that is just now starting to emerge.

But contrast their pattern of investment in recent years with ours. What sector in our economy has expanded more than any other? Where should you work if you want both the highest wages on average, potentially very big bonuses, and quasi-retirement by age 40? Finance.

Of course, we need finance and an important part of modern economic development involves intermediating savings and investment. The US did this well, with some bumps in the road, and built a system that worked through the 1960s or 1970s.
But finance as a share of our activities (i.e., percent of GDP) has roughly doubled in the past 40 years. What has this really added in terms of productivity? The ATM and the credit card were great breakthroughs, but they are old.

What has “financial innovation” brought us since the 1980s? One answer, of course, is “hedging strategies” that lower the cost of doing business for companies large and small. This is plausible, although not likely to be large relative to the economy - send me your favorite study on the cost of capital since 1990 (you choose the definition), and we can talk about whether this effect is significant, sustainable, or even sensible.

Because financial innovation has mostly facilitated a big increase in finance. If a sector grows, pays more wages, and rises as a share of GDP, surely this is a good thing? Not necessarily – if this is a rent-seeking sector.

Rent-seeking means effectively a tax extracted by one sector from the rest of the economy. We’re used to thinking of this as something that occurs through trade restrictions and the big breakthroughs in this area came from analysis of tariffs and quotas (Anne Krueger, Jagdish Bhagwati). If a tariff, for example, will make your life cushy, you will devote great resources to getting one established or increased – irrespective of the effects on the rest of the economy (call this strategy “let’s hammer the unprotected consumer”).

Finance is rent-seeking. The sector has devoted great resources to tilting all playing fields in its direction. Consumers are taken advantage of; consumer protection is vehemently opposed. And great risks are taken, with the downside handed off to the government (and the consumers again, as taxpayers). This downside protection allows an overexpansion of debt-financed finance – reaching the preposterous levels seen in mid-2008 and now re-emerging.

Finance in its modern American form is not productive. It is not conducive to further sustained economic growth. The GDP accruing from these activities is illusory – most of finance is simply a tax on what is done by more productive members of society and a diversion of talent away from genuinely productivity-enhancing activities.

The rise of China does not necessarily imply slowdown or demise for the United States. But if they specialize in making things and we specialize in finance, they will eat our lunch.
On an urgent basis, we need real consumer protection against predatory financial practices and an end to all forms of Too Big To Fail behavior – which is actually just the biggest, nastiest form of predation.

This is our most pressing national and international strategic priority.

By Simon Johnson
Yet More on Health Insurance

James Kwak  |  11 Aug 2009

Simon and I have a kind of synthesis of our recent thoughts on health care reform, along with some more data and thoughts about the employer-based system, up at The Hearing. It seems to have 167 comments – people really like to talk about health care, don’t they?

On a related note, we will be modifying the format of our Washington Post gig. We’re moving in the direction of a weekly, substantive opinion and analysis piece, rather than trying to keep up with Congressional hearings from day to day. We’ll get you a new link when that is fully up and running.

By James Kwak
Richard Parsons’s Portfolio

Simon Johnson | 12 Aug 2009

According to Bloomberg, Richard Parsons – the chair of Citigroup since February – now owns stock in the company worth, at yesterday’s close, about $350,000 (96,298 shares at $3.69). For such a well-established and highly remunerated corporate executive, we can reasonably refer to such an amount as “chump change.” In May, Forbes estimated Mr. Parsons’ net worth as a little under $100m.

I have no particular complaint about Mr. Parsons; he is an experienced banker, with the very best political connections. But I would point out that while Wall Street likes to talk big about people having “skin in the game,” when it comes to putting their personal net worth on the line, many finance executives prefer a different kind of arrangement. Specifically, they are attracted to compensation structures in which they have a lot of upside but very little downside.

If you had such a deal, how would this affect your relative interest in risk-taking and careful supervision of subordinates?

David Brooks famously argued, a few months ago, that the problem with our banking system circa 2008 was not anything about incentives and political power, but rather stupidity. Probably he was right that this mattered in some degree for the housing bubble.

But what should we think about an industry that is carefully and deliberately constructing the exact same arrangements again? Won’t this lead us inexorably towards a Truly Great Bubble? Stupidity involving smart people in well-heeled organizations must surely be about incentives for those at the top.

Just because these arrangements involve and are being implemented by a member of President Obama’s Transition Economic Advisory Board, does that make them OK – or even remotely sensible?

And where exactly do you see the impact of the administration’s vaunted regulatory reforms for the financial sector here?

If your response is “well, that’s the system and there’s nothing you can do about,” you have a point. But if that’s your response and you work in the White House, we all have a very big problem.

By Simon Johnson
The Problem with Disclosure

James Kwak | 13 Aug 2009

Felix Salmon has a good example of why disclosure (the preferred consumer-protection regime of free-market conservatives and bankers) doesn’t work, courtesy of Ryan Chittum. The topic is no-interest balance transfers offered by credit card companies.

As Salmon points out, most people probably realize what the game is. That is, most people know that banks aren’t in the business of lending money for free; they know that the bank is betting that it can raise the interest rate before they pay off the balance. It’s possible that you will end up getting a free loan: “If you’re smart and disciplined and lucky, you might be able to game the system and pay no interest at all on that balance. Bank of America, for its part, does its very best to make you think that you’ll be able to do just that, essentially getting one over on The Man.” But the bank knows it has the numbers on its side; and most consumers know it too, because they know that’s the only reason the bank would make the offer.

And people take the bait anyway, because they think they’re the exception. “Most people, when they sign up for one of these offers, think that they’ll successfully game the system. But of course most of them are wrong.”

The people who think that disclosure solves everything, like Peter Wallison, are remembering only half of what they learned in first-year micro. In order to get utility-maximizing outcomes, you need perfect information and rational decision-making. Disclosure gives you information about the product you are buying, but it doesn’t make you a rational actor – especially not when you have to make predictions about your own future behavior. Remember, not only are we a species in which 90% of people think they are above-average drivers, but 85% of people in hospitals who just caused auto accidents think they are above-average drivers. (Sorry, I can’t remember where I heard that – it was recently, probably on an NPR show.) (Update: engineer27 found the story – it’s from the Planet Money team.)

I suspect that the real divide in the battle over the Consumer Financial Protection Agency is between outcomes and principles. CFPA supporters believe that policies should attempt to achieve the best possible outcomes for the largest number of people; if the number of people harmed by a product exceeds the number helped, then it should
be banned, or at least made harder to buy. CFPA opponents believe that policies should faithfully reflect certain principles; in this case, people should be free to make their own financial choices, even if in aggregate most people will make bad choices, and they should bear the consequences of those choices.

This is a fairly common way that policy debates break down these days. Sex education and contraception are the best example, but there’s a similar fault line when it comes to guns, drugs, and crime, among other things. It’s also an indication that the debate can never be resolved by any amount of empirical data.

*By James Kwak*
Can the Federal Reserve Protect Consumers?

Simon Johnson | 13 Aug 2009

Ben Bernanke, chairman of the Federal Reserve, insists that the Fed can protect consumers effectively against defective or dangerous financial products. He and his allies are therefore signaling opposition to – and even defiance of – key parts of the Treasury’s plan for regulatory reform, which involve setting up a new Consumer Financial Protection Agency.

The Fed is a well-regarded institution in general and Bernanke is currently riding a wave of personal popularity and prestige, but are these claims vis-à-vis consumers plausible?

Not really.

The heart of the problem here lies with the Federal Reserve Act. As it currently stands, the all-important Section 2A reads, “The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy’s long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.”

This is what the Fed does – in practice by trying to keep unemployment down (ideally around the 4-5% mark, although that can change over time) and inflation low (no more than 2%, roughly).

Formal objectives matter for central banks because they have to weigh trade-offs – “if we try to lower unemployment, what will that do to inflation?” etc – carefully in deciding where to set short-term interest rates and other dimensions of their support to the credit system.

Consumer protection is not in this mix and you can tell. No one can seriously tell you what a great job the Fed has done protecting consumers. For example, the Fed has dragged its feet for years on coming up with a sensible definition of the Annual Percentage Rate on loans, i.e., a measure that includes all costs. As a result, many borrowers have been misled effectively by lenders.

More broadly, Alan Greenspan famously stood by despite being warned by his colleagues about the housing bubble and the associated abuses of consumers. As the housing frenzy developed in 2003 and low income people got sucked in and – many of them – suckered, Ben Bernanke argued for a further lowering of interest rates on the basis of
short-run macroeconomic considerations; apparently he was oblivious to the dangers that implied to consumer-as-borrowers.

As Rep. Barney Frank (D-Mass.) said at the height of the housing madness in 2007, “If I was going to list the top 87 entities in Washington in order of the history of their efforts on consumer protection, the Fed would not make it.”

What would happen if you tried to add formal protection of consumers to the top level of Fed priorities and to make it central to Bernanke’s job?

This would surely require amending the Federal Reserve Act, otherwise consumer protection would remain a second class citizen at the Fed. The Fed is not a government department, it’s an independent entity. If you don’t give the Fed specific legislative direction and detailed reporting requirements for a particular task, it won’t get done.

And even that may not be enough. The Fed has plenty of powers to help consumers, but it just hasn’t used them. The American Banker (subscription required) quotes Barney Frank on this also, “One of the greatest unused examples of power were the consumer protection powers we’ve given the Fed.”

Why? Again, Frank – as chair of the House Financial Services Committee – should know, “If you look at the Fed governors, their focus has been on the safety and soundness of the banking system, not consumers.”

The tip off here is that banks of all kinds want enforcement of consumer protection laws to stay with existing bank regulators where, John C. Dugan, Comptroller of the Currency claimed recently “it works well.” But he doesn’t mean that this arrangement protects consumers. He means that it protects banks and the banking system – whenever necessary (like now) consumers can be squeezed to improve the banks’ bottom line.

The Federal Reserve never has and never will put consumers first.

By Simon Johnson

A slightly different version of this post originally appeared on the NYT.com’s Economix blog. It is reproduced here with permission. If you wish to repost this material in its entirety, please contact the New York Times.
Health Care’s Senior Moment

James Kwak | 14 Aug 2009

Seniors have recently emerged as an important battleground in the health reform war. Katharine Seelye of the New York Times has a post on the “new generation gap” separating the elderly from the not-so-elderly, and multiple polls have shown that seniors are more resistant to reform, at least when it is phrased broadly. In addition, the nonsense about “death panels” has worried at least some seniors, enough for the AARP to pitch in to try to shoot it down.*

This should seem ironic, given that people over 65 are the one group that has already most benefited from health care reform – only their reform happened in the 1960s, when Medicare was created. But hey, it’s a democracy, and people don’t have to wish for others the benefits they themselves enjoy.

What are the underlying reasons why seniors are more likely to oppose “reform?” The first – leaving aside the self-contradicting notion that health care reform will mean a government takeover of Medicare – is probably fear that Medicare will be negatively affected. Now, there is a grain of a partial truth to this fear. Several of the proposals on the table include paying for health care reform (meaning, paying for the subsidies that poor people will need if we’re going to mandate universal coverage) in part by reducing growth in Medicare spending. One proposal is the Independent Medicare Advisory Committee, which would look for ways to increase efficiency in Medicare, which could include lower reimbursements for procedures that were deemed to be not providing benefits commensurate with their costs.

To its credit, here’s what the AARP** has to say about health care reform and Medicare:

**What do the proposals say?** It’s true they all seek to save billions from Medicare costs—not by cutting benefits, but by setting up new ways to pay doctors more fairly and to reward providers for quality of care instead of (as now) paying them a fee for each separate service; reducing waste and fraud; and reducing preventable hospital readmissions.

All the proposals would cut the amount of subsidies now paid to Medicare Advantage private health plans, which cost an average of 14 percent more per person than traditional Medicare does.
Without subsidies, the private plans could become more efficient, or they could raise premiums, reduce benefits or withdraw from Medicare.

The proposals also add benefits to Medicare—such as covering more preventive services and narrowing the Part D “doughnut hole.”

More fundamentally, though, the need to reduce growth in Medicare spending stems from the simple fact that otherwise Medicare will blow through the entire Federal budget within the next few decades. Not reducing the Medicare growth rate is not an option. If I were a senior, or expected to be one in the next couple decades, I would very much want health care reform now, because the alternative will be much more draconian cuts to Medicare benefits in the future as the national debt explodes.

And reducing costs is precisely the other thing that seniors care about. According to Seelye, concern about health care costs rises with age. Now this makes sense; even with Medicare, seniors’ out-of-pocket medical expenses are considerably higher than those of younger people, for the simple reason that on average they consume more medical care. But there’s no good way to reduce seniors’ out-of-pocket spending without at the same time reducing Medicare spending because, broadly speaking, those two types of spending are buying the same thing – health care. You can’t have a system where Medicare spends more and more yet seniors spend less and less out of pocket (short of simply reducing seniors’ relative contribution to their health care costs, which would only make the fiscal problem worse).

It’s simply contradictory to oppose reductions in the growth rate of Medicare spending while favoring reductions in your out-of-pocket spending. Of course, there’s nothing that prevents people from holding two logically inconsistent thoughts in their heads at the same time. Uwe Reinhardt had a brilliant column a couple of weeks ago on the stew of inconsistencies that many Americans take for granted when it comes to health care.

Luckily, they elect representatives who can think clearly about these complex issues. Oh, wait, sorry about that.*

* On the other hand, what the hell does Chuck Grassley – one of the six people who think they are writing the health care bill – think he’s doing, saying “We should not have a government plan that will pull the
plug on grandma?” As Brad DeLong might say, why oh why does he have a seat at the table?

** As far as I can tell from their website, the AARP is neither for nor against health care reform in general; they say they are working to make sure that health care reform is good for their constituency.

*By James Kwak*
Waiting For The Federal Reserve’s Next Apology

Simon Johnson  | 14 Aug 2009

In November 2002, Ben Bernanke apologized – for the Fed’s role in causing the Great Depression of the 1930s. “I would like to say to Milton [Friedman] and Anna [Schwartz]: Regarding the Great Depression. You’re right, we did it. We’re very sorry. But thanks to you, we won’t do it again” (conclusion of this speech).

Bernanke’s point, of course, is that the Fed tightened monetary policy inappropriately – and allowed banks to fail – in 1929-33. And much has been made of his strong focus, over the past year, on avoiding a repeat of those or closely related mistakes (including here).

But today we need a different kind of apology, or at least a statement of responsibility, from Ben Bernanke and the Fed.

From the Federal Open Market Committee meeting transcript of August 2003, we know that Bernanke said, “Despite the good news, I think it’s premature to conclude that we should not consider further rate cuts, if not at this meeting then at some time in the near future depending on how the data play out” (p.63).

He was concerned not just to keep interest rates low for a prolonged period but also to signal this to financial markets, “To the extent that we can sharpen our message that economic growth no longer implies an immediate and automatic policy tightening, we should make every effort to do so” (p.65; see also his role in the broader discussion around p.93).

This was, of course, at a time that the speculative fever and outright malpractice in the housing market was really taking off. The build-up of financial market risk was starting to head towards system-threatening dimensions. And many consumers were being set up for a trampling of epic proportions. It is striking there is barely a mention of these issues in the FOMC transcripts.

And that’s the issue. We can argue for a long time about whether the Fed should have tightened earlier. Defenders of the Fed will say the data were ambiguous – and will point to the serious discussion of these issues in the FOMC transcript.

We can also dispute whether or not the Fed should have said anything in public about the impending housing-financial-consumer-taxpayer doom, or tried to tighten regulation. “It’s not our job” or “we don’t have
the powers,” or “the politicians wouldn’t have supported us” is what senior Fed people now whisper around Washington.

But this and other FOMC transcripts make it clear that the senior Fed decision makers were not even thinking about the first order financial sector issues. They weren’t aware of what the big investment banks were really doing – show me the intelligence reports before the FOMC or the analytical discussion that indicated any degree of worry. No doubt someone somewhere in the Federal Reserve system was thinking critically about finance – feel free to send me any relevant details - but from the point of view of evaluating the institution, it only counts if the top decision-making body at least has the issues on the table.

We have transcripts so far through the end of 2003. Others should be forthcoming soon; there is supposed to be only a 5 year lag in their publication. But, given their likely content, it would not be a surprise if the appearance of these transcripts slows down.

At this moment of potential regulatory reform, who within the Fed really wants us to know that their leadership in the Greenspan era completely framed the problem wrong, didn’t understand what was happening, and repeatedly, brazenly, and callously ignored the damage being done to consumers?

I fully understand that financial market considerations are not the established focus of central bank interest rate deliberations. But the scope and nature of such deliberations has changed a great deal since the founding of the Fed almost 100 years ago. As the economy changes, central banks have to adapt their conceptual frameworks and our broader regulatory frameworks need to change also. We’ve done this many times before, and we need to do it again.

Huge problems were missed by people using anachronistic conceptual frameworks. Those frameworks should change. This was the assessment of Ben Bernanke, building on Friedman and Schwartz, for 1929-33, and this should be our assessment today.

Our top monetary policy makers completely missed the true nature of the Great Bubble and its consequences, until it was far too late. They should apologize for that and we can start work on redesigning the institution, its decision-making, and how financial markets operate, to make sure it won’t happen again. And it would also be nice if the Fed could avoid adding insult to injury – and stop opposing the administration’s consumer protection proposals.

Hopefully, this time the Fed’s apology won’t take 70 years.
An Inside Perspective on Regulatory Capture

James Kwak | 15 Aug 2009

We received the following email from James Coffman in response to Bond Girl’s recent guest post, “Filling the Financial Regulatory Void.” Coffey agreed to let us publish the email. As he says below, he spent 27 years in the enforcement division of the SEC.

Bond Girl’s “Filling the Financial Regulatory Void” provided insight into human deficiencies in the current financial regulatory system. But it overplays the human failings of regulators and concludes with a proposed solution that, in all likelihood, would turn out worse than the current situation. But first, in the interest of full disclosure, I should tell you that I retired two years ago from a management position in the enforcement division at the SEC after 27 years. So I was (and in my heart, I suppose I still am) a financial regulator. That background probably should be taken into account by anyone who reads this response.

There is no doubt that “regulatory capture” exists and is a meaningful factor in the recent failures of our regulatory system. Many of us in the enforcement division dealt with the problem regularly when we sought input from those in the agency who were responsible for regulating aspects of the securities markets. Over time, regulatory policies and practices had emerged that seemed to contradict the purpose if not the letter of the law. In other cases, over-arching issues (e.g., increases in fees charged by investment companies despite growth that should have resulted in economies of scale and decreasing fees) simply were not addressed in any meaningful way.

But the majority of regulators I worked with were critics of the problem of “capture,” not victims. Much of the problem arose from decades of deregulation dating back to the beginning of the Reagan administration. Elected deregulators appointed their own kind to head regulatory agencies and they, in turn, removed career regulators from management positions and replaced them with appointees who had worked in or represented the regulated industries. These new managers and, in many cases, the people they recruited and promoted, advanced or adhered to a regulatory scheme that, at least with respect to the most important issues, advanced the interests of the regulated.

Bond Girl is right, the industry “captured” the regulators and the regulatory system. But not in the passive sense that true regulators over time came to identify too closely with the interests of the regulated. This
is not a case of financial regulators falling victim to the Stockholm syndrome. The vast majority of capture resulted from intentional efforts by the finance industry to advance their narrow interests at all costs and defeat meaningful regulation. Unfortunately, we live in a country that can be bought from the top down and the finance industry exploited the situation very successfully. But do not blame the regulators. Career regulators are as much the victims of these events as the public’s economic welfare.

The creation of paid social entrepreneurs to perform regulatory functions will not enhance regulation nor reduce “capture”. I’ve sued too many CPA’s over the years for bad audits to believe the answer lies in creating a new class of auditors. Audit clients often “capture” their auditors. The result is bad audits resulting in uncorrected and undisclosed financial fraud. The victims are always the shareholders and the market. Besides, using money to “incentivize” a new, private class of regulators plays directly into the hands of the finance industry. No matter what the regulatory fee structure may be, government will never be in a position to compete with the financial industry when it comes to “incentivizing” regulators-for-hire.

We need to look elsewhere for solutions to the problems that hamper our financial regulatory system.

• First, we need to look at the structure of the finance industry. Commercial banks got into trouble in large part because they warehoused (often off the books) toxic securities underwritten by their investment banking counterparts within the holding company structure. Similar abuses in the past resulted in separating investment banking from commercial banking. We should try it again. Insurance should be split off as well.
• Second, no institution should be allowed to become too big to fail. Those that have already achieved that status should be broken up.
• Third, we must put in place an effective financial consumer protection agency which can counteract the worst consumer practices of a too powerful industry.
• Fourth, investment banks should be made to eat what they kill. Public ownership of investment banks coincided with the industry’s decline into extremely reckless risk taking. Investment bankers should be required to own a significant percentage of the equity in the institutions in which they work (something approaching 50%, to pick a number). Having a significant portion of their net worth tied up in such stock would provide an
incentive to carefully identify and measure risk. It should also reduce outsized compensation for investment bankers.

- Fifth, there should be greater limits placed on the ability of political appointees to oust career regulators. Make capture more difficult.
- Sixth, more financial products and firms should be subject to government registration and reporting.
- Seventh, regulators should not be forced to wear conflicting hats. One cannot promote an industry while protecting the public from it. Don’t ask regulators to be industry cheerleaders. Limits can be placed on regulators to ensure that they not act without consideration of the impact of their actions. But over-regulation is not what got us in this position. Cheerleaders purporting to be regulators did.
- Finally, the government should adopt a bonus plan for regulators, run by regulators (who would rotate off after short, fixed terms, to prevent back-scratching among board members) to provide incentives for regulators to excel at the job of regulation. Recognized, protected and incentivized regulators will resist capture.

By James Coffman

Update: Bond Girl responds.

Update 2: I (James) had the author’s name wrong – it should be Coffman, not Coffey.
Management Consulting for Humanities Ph.D.s

James Kwak | 15 Aug 2009

Ezra Klein referred me to a 2006 article, “The Management Myth,” by Matthew Stewart, which has just led to a new book by the same name. Stewart has a Ph.D. in nineteenth-century German philosophy and was a founding partner of a management consulting firm; I have a Ph.D. in twentieth-century intellectual history and spent three years as a management consultant (at McKinsey) before co-founding a software company, so I thought I might find a kindred soul. Also, I’ve been thinking for years that I should write a book about my strange journey through the business world, but will probably never get around to it, so I was wondering what that book might have looked like.

Well, we’re not so kindred after all, although my criticisms of the management consulting industry certainly overlap with his. One difference: I have never, ever found myself thinking, “I’d rather be reading Heidegger!,” although (or perhaps because) I read my share of Heidegger back in the day – Being and Time was on my orals list. (That said, I have also never read books about management, which is what Stewart was doing when he was wishing for Heidegger.)

Stewart is full of scorn for the “management literature” – meaning books with big fonts, bullet points, and truisms disguised as buzzwords – and I’m sure that scorn is well-deserved. But he blurfs that scorn into scorn for the management consulting industry itself. And while the latter may deserve scorn for its own reasons, I think the two – the books and the consulting firms – are quite different.

As a management consultant, on an actual project, I can’t recall anyone ever discussing, let alone taking seriously, anything he or she had read in a business book or learned in a corporate strategy class. Our main job was digging up information, doing analysis that was trivially lightweight by academic standards but more than most companies do on their own, and packaging the whole thing into a coherent storyline that made a point. What McKinsey brought to the exercise was smart people who were willing to work extremely hard and obsess about trivial details until late at night – for example, after photocopying presentations for a client, someone had to flip through them to make sure that none of the pages got rotated or pushed off-center by the copier – along with some core skills in turning relatively little data into a convincing-sounding story.
As for getting an MBA, I would say that 90% of the consultants I knew already acknowledged what Stewart argues – it’s not what you learn at business school that matters, it’s the screening function. Top business schools screen for the attributes that certain types of companies, including consulting firms and investment banks, value – above-average intelligence, ambition, presentability, ability to get along with others, willingness to follow orders, and a strong streak of conformism. McKinsey recruits people with Ph.D.s (and certain other advanced degrees) as well because the Ph.D. is an indicator of intelligence and (to some extent) ambition, but it is considerably harder to get a consulting job as a Ph.D. from a top school than as an MBA from a top school because of the other things that an MBA signals. But the point is that everyone knows this already, and many people still choose to go to business school, because it’s the rational choice given the job market.

I think the biggest problem with management consulting is that most of the work on a project is done by junior people who know absolutely nothing about the industry they are serving, and don’t even realize how little they know. (And generally the partners don’t know that much, either, since many of them have never worked anywhere except in consulting or maybe banking.) Having worked as a consultant to the software industry and then as an employee of the software industry, I have seen this from both sides, and I’m embarrassed for the naive consultant I used to be. But it’s also true that many of our clients could not have assembled teams of people to do the kind of work that we were doing – not because they didn’t have the right people, but because those people are invariably too important to be freed up from their day jobs.

I hear that in the legal industry more and more clients are refusing to let law firms bill them for first-year associates. I think that the consulting industry will probably move that way. But even so I think there is some place for management consulting firms.

By James Kwak
Has Anyone Taken Responsibility For Anything? (Weekend Comment Competition)

Simon Johnson  |  15 Aug 2009

With the anniversary of the Lehman-AIG-rest of the world debacle fast approaching, it seems fair to ask: Who accepts any blame for creating our excessively crisis-prone system?

Friends and contacts who work in the financial sector freely discuss their participation in activities they now regret. But where is the mea culpa, of any kind, from a public figure – our “leadership”?

I suggest we divide the competition into three classes.

1. Policymakers who now admit that any of their actions or inactions contributed to the Great Credit Bubble. Blaming China gets a person negative points; this may hurt Fed officials.

2. Private sector executives who concede they made mistakes or misjudged the situation so as to lose a lot of Other People’s Money. Blaming Hank Paulson also earns negative points (too obvious).

3. Anyone charged with safeguarding consumers, in either public or private sector capacity, who now says that they or their organization did a completely miserable job. My guess is that you will find precisely no one in this category.

You can award points for style, timing, and extent of the apology or near-apology.

Feel free to suggest other categories or to propose additional scoring rules.

By Simon Johnson
At the Beach

James Kwak  |  15 Aug 2009

I will be at the beach with my family for a week. I’m not certain about this, but there is a strong possibility that I will not be using a computer, let alone checking email or blogging. (Computers are useful when traveling, especially since I don’t have an iPhone or a Blackberry, but if you have one then there is the temptation to check your email, and then you are on a slippery slope to hell.)

Luckily for you, Mike Konczal, aka Mike Rorty, of Rortybomb and The Atlantic, has agreed to be my stand-in for the week and will be guest-blogging here. Mike is a bona fide financial engineer with the good sense to live in the San Francisco area, and is a natural with economics, finance, public policy, and the English language.

Enjoy.

(Simon will probably still be blogging, although he will also be on vacation; in fact, he has been on vacation for the past week.)

By James Kwak
Hello all, my name is Mike Konczal and I’ll be guest-blogging here this week. I want to start off with a request for comments. I think this page has one of the smarter comments sections (that statement is completely self-serving, as I am a commenter here too), and I want to get all of your opinion on a question that I’ve been thinking about lately: Where did the increase in demand for housing and subprime loans come from?

Think of our current story for the increase in subprime loans and the housing bubble: interest rates were kept too low following the attacks of 9/11 and/or there was a global savings glut. Financial deregulation allowed Wall Street to pour capital into mortgages while slicing and dicing them into investment vehicles, and politicians were happy to think the interests of Main Street (and its voters) and Wall Street (and its campaign donations) lined up perfectly. Fly-by-night unregulated subprime lenders steered borrowers into high-interest loans and/or community groups pressured banks to increase the amount of said loans, as well as restricted the increase in new houses in the most desirable areas through regulation and zoning. Alyssa Katz’s Our Lot is the best book I’ve read recently about the way deregulation and political goals worked together to get Wall Street to pour money into dubious loans.

Notice that almost all of these are changes are on the supply side: Someone now wants to offer you more of a mortgage than they did before. But why did we take these mortgages? We could say that supply creates its own demand, but I think that’s too much of a dodge when there are interesting phenomenon to investigate. Here are two standard ones:

Perfectly Rational Karl Smith points out that there may not be a conflict here at all. When it comes to no-money-down liars loans, or leveraged investments more generally, the effect for consumers might be a “heads-you-win, tails-nothing-happens” coin flip. If someone offers you a giant mortgage, and the upside that your new house may become worth a lot more than the fees and interest jumps, and the downside is that you got to live in a nicer house than normal for a year or two and lost your rent, that’s a perfectly rational bet.

That’s not the experience on the ground, where people hang onto their house, fighting, often desperately at times, to keep them. Houses aren’t
dumped like underperforming stocks by the overwhelming majority of consumers.

**Investments Gone Bad** Interest paid on a mortgage is tax deductible. In 1997, President Clinton overhauled the tax code for selling real estates; consumers would no longer have to pay capital gains taxes on their houses. Between that, the collapse of the tech bubble and the worry that there were many more Enrons and Worldcoms waiting to be found, many households didn’t want to invest in the stock market. So people went nuts and invested too heavily in housing for their investment portfolio.

(Technically, if people want to spend more on houses because interest rates are lower, then the interest rate tax deduction may have slowed the housing bubble, since if people are buying more house because interest rates are lower then they must have less interest paid on their house, which is less to write off on their taxes.)

This depends on housing prices appreciating for a long time – here’s an example of economists discussing whether or not that is rational, and trying to fold it into a standard investment story. I often feel that when the story goes too quickly into “irrationality”, it is because we are missing some sociological explanations for why people are doing the things they do. I want to add three additional reasons why the demand for housing may have skyrocketed over the past 10 years, ones I don’t see discussed very often in the standard narrative.

**Housing Equity as the new Social Contract** As income has become more volatile, health care costs have skyrocketed, unemployment spells have increased, more household spending has gone to hard-to-decrease fixed costs, and all the while there has been a slow unwinding of the social contract, housing equity became a new form of social insurance to navigate the bad times.

A lot of housing equity was tapped to make large consumer purchases – televisions, remodeled kitchens, etc. But a lot of housing equity was tapped to pay medical bills, or as a form of unemployment insurance, as well. It is worth noting that 60% of subprime loan defaults in Massachusetts started off as prime loans, the previously stable households who put money down, paid their bills on time, etc. I’d be curious to see research focused on how much of each played a part in the housing bubbles and demand for subprime loans, and the rise in house prices more generally.
**Education** There’s a lot of focus on the interest rate deduction that is embedded inside a mortgage. I think the most obvious embedded option inside a mortgage that isn’t discussed is the option to educate your children at the local school district. If sending 3 kids to a private high school at your old houses costs $5,000/year, and if the new house’s public high school is free and equally good then taking a $60,000 bath on the house is break-even. Completely rational.

The value of this option has increased, both with the returns to education but also with a general worry about the robustness of our educational meritocracy. The amount of money and energy that goes into securing access to high-end education has skyrocketed over the past decade, and part of that budget, though it isn’t treated as such, is in your house. And though we often think of educational inequality as a function of a Kozol-narrative of the poorest against the richest, this bidding may be most driven by inequality between the middle and the highest parts of the inequality curve. I’d really like to see some hard research into how much our desire to educate our children in the best way possible has driven subprime and the housing bubble.

**Gentrification** The term gentrification may not apply anymore, as it usually is meant to describe a small neighborhood. What we’ve seen might be described as a demographic inversion, with the poor being moved from the city to the suburbs. That New Republic article focuses on Chicago, and as a resident of Logan Square during the time in question I can back up the statement: “The reality of demographic inversion strikes me every time I return to Chicago...But that hasn’t prevented Logan Square from changing dramatically again—not over the past generation, or the past decade, but in the past five years.” Even now, with the housing recession underway, it seems that we’ll continue to see a shift to a “new urbanity” over the next ten years.

Gentrification can increase the quality-of-life for people who remain in the area. There will be better services, safer streets, the kind of grocery stores where people with college degrees shop, etc. However the key point there is that people have to remain in the neighborhood. Taking a big bet on housing can be very rational in this case. The rollercoaster jumps in mortgage payments that come from a subprime loan might be less than the uncertainty in the jumps in apartment rents that occurred over the same period.

If you were an adult in the 2000s, you’ve probably spent at least one night thinking “am I making the right housing choices? Should I buy?
Should I have bought more? Less?" Since this is the smartest comments section on the nets, I’d like to ask you – why was this?
A CFPA Research Brief

Mike | 17 Aug 2009

I want to point out this research brief on the Consumer Financial Protection Agency (pdf file) from Law Professor Adam Levitin. At 16 pages, it’s the best one-stop paper I’ve seen for understanding why CFPA needs to pass.

As opposed to specific practices, Levitin focuses on four key structural issues that are broken with our current system.

1. Consumer protection conflicts with, and is subordinated to, safety-and-soundness concerns.
2. Consumer protection is a so-called “orphan” mission.
3. No agency has developed an expertise in consumer protection in financial services.
4. Regulatory arbitrage of the current system fuels a regulatory race-to-the-bottom.

The first point is key and informs the rest of them. “Safety-and-soundness” means that regulators currently are focused on making sure the banking system is sound, part of which means that banks have lots of money. So if Americans are paying a mind-boggling $38.5 Billion dollars in overdraft fees a year (more than the GDP of Kenya, as a comparison) that just means regulators can sleep a little more soundly at the wheel.

If having giant banks dedicated to soaking and misleading consumers was creating a safer and more sound financial system, that would be one thing, though preliminary evidence says no:

Since protecting large banks at the expense of consumers is the current goal of the regulatory structure, other goals such as collecting data on actual experiences of consumers (something researchers have a difficult time finding, and have to use poor substitutes like aggregate consumption diaries), having in-depth knowledge locally on scene, and fighting regulatory arbitrage among the current 11 agencies that investigate this material fall by the wayside.

Levitin also brings up this point, mentioned again and again (and worth mentioning again): “Most consumer financial products differ in their class primarily on price, not functionality, but product pricing structure is designed to make comparison shopping difficult in order to avoid commoditization (and inevitably lower profit margins). Better disclosure should encourage commoditization and price competition, which should actually bring down prices.”
If you are in the business of reading or disseminating research papers, I’d recommend that Levitin paper. Though health care is rightfully focusing our minds and attentions these days, this is another piece of necessary reform that could get easily thrown under the bus.
United States Inequality in the Recovery Period

Mike | 18 Aug 2009

I want to point out this post from the LA Times, The consumer isn’t overleveraged — the middle class is:

That’s one conclusion to draw from a new Bank of America Merrill Lynch report this week, “The Myth of the Overlevered Consumer.”

The report hammers home what you might already suspect: The consumer debt problem in the economy really is a debt problem for the middle class. The need to work off a chunk of that debt will sap middle-class families’ spending power for perhaps years to come.

By contrast, the upper 10% of income earners face a much smaller debt burden relative to income and net worth. Those people should have ample spending power to help fuel an economic recovery.

Using 2007 data from the Federal Reserve, BofA Merrill defines the middle class as people in the 40%-to-90% income percentiles. It defines lower-income folks as those in the zero to 40% income percentiles, and the wealthy as those in the top 10%.

I looked at similar data here; what I find interesting is one of their conclusions, one I’m trying to think through these days. There’s a general assumption that, to whatever extent historically record-high inequality is present, it will almost certainly be gone post-recession. But what if it isn’t? What if this recession, and the recovery, will cement inequality in the United States even further? From them:

What’s more, on the asset side, BofA Merrill says the middle-class has suffered more than the wealthy from the housing crash because middle-class families tended to rely more on their homes to build savings through rising equity. Also, the wealthy naturally had a much larger and more diverse portfolio of assets — stocks, bonds, etc. — which have mostly bounced back significantly this year.

There are a lot of moving parts going on with the interaction between the top percents and the middle class, inequality and collapse, but it isn’t
hard to see a story where the stock market picks up, housing is in decline for a decade, and we have a jobless recovery. I’m not sure how that would effect our quantitative measures of inequality, like the gini coefficient, but we could end up with much more inequality, and inequality that stings a lot harder than it did during the boom times.

I bring it up because, in a separate analysis of similar data, Zero Hedge made similar points in their massive weekend A Detailed Look At The Stratified U.S. Consumer (my underline):

…It is probable that the dramatic increase in savings as disclosed previously, is an indication that at long last the richest 10% of America may be finally feeling the sting of a collapsing economy. Yet estimates demonstrate that even though on an absolute basis the wealthy are losing overall consumption power, the relative impact has hit the lower and middle classes the strongest yet again...

The main reason for this disproportionate loss of wealth has to do with the asset portfolio of the various consumer strata. A sobering observation is that while 90% of the population holds 50% or more of its assets in residential real estate, the Upper Class only has 25% of its assets in housing, holding the bulk of its assets in financial instruments and other business equity. This leads to two conclusions: while average house prices are still dropping countrywide, with some regions like the northeast, and the NY metro area in particular, still looking at roughly 40% in home net worth losses, 90% of the population will be feeling the impact of an economy still gripped in a recession for a long time due to the bulk of its assets deflating. The other observation is that only 10% of the population has truly benefited from the 50% market rise from the market’s lows: those better known as the Upper class.

And to add insult to injury, the segment of housing that has been impacted most adversely in the current downturn, is lower and middle-priced housing: that traditionally occupied by the lower and middle classes. The double whammy joke of holding a greater proportion of net wealth in disproportionately more deflating assets is likely not lost on the lower and middle classes.

Consumption and savings might be hit relatively harder among the working and middle classes, as their primary investment vehicle deflates away while green shoots in the financial markets should kick start the
healing for the upper classes. I don’t want to put my name too strongly on these predictions, because this part of the economy is very uncertain, but it’s a development I’m watching very closely.
Vermont, Texas, and Subprime Loans

Mike  | 18 Aug 2009

The Wall Street Journal has a story about Vermont and subprime loans:

...For the past five years, as home loans went to even Americans with poor credit and no proof of steady work, Ms. Todd couldn’t get a mortgage in spite of her good credit and low debt. Vermont banks told the self-employed landscaper that her income stream was unreliable. The 32-year-old changed careers, taking a permanent job as a teacher, to boost her chances.

Vermont’s strict mortgage-lending laws largely prevented the state’s residents from signing the types of dubious home loans written in other markets across the country. Its 1990s legislation made mortgage lenders warn customers when their rates were relatively high, and put the brokers who arranged loans on the hook if their customers defaulted. Now, by at least one measure, the state has the lowest foreclosure rate in the U.S...

These tendencies help explain how, in the 1990s, the state moved to rein in mortgage lenders based on just a few instances its chief regulator says raised red flags. According to Vermont’s Department of Banking, Insurance, Securities and Health Care Administration, one broker solicited customers through newspaper classified ads, charging up to $5,000 for referring customers to a lender. Another searched property records for owners’ tax liens, a town clerk reported, searching for what the department believes were people who could be desperate to borrow....

In laws passed between 1996 and 1998, Vermont required lenders to tell consumers when their rates were substantially higher than competitors’, with notices printed on “a colored sheet of paper, chartreuse or passion pink.” And in what officials believe is the first state law of its kind, Vermont declared that mortgage brokers’ fiduciary responsibility was to borrowers, not lenders. This left Vermont brokers partly on the hook for loans gone sour...

Vermonters didn’t see the same sharp rise in home ownership that swept much of America in recent decades, which, despite the
bust, buoyed economic growth. And while part of the increase in U.S. home ownership reflected excesses in lending and borrowing, some of it represented real progress in the form of more Americans achieving the cherished goal of getting — and keeping — a home of their own. By 2007, the percentage of owner-occupied households as a whole reached 68.1%, up from 63.9% in 1990, according to U.S. Census data. Vermont started at a higher base but saw ownership rise just 1.1 percentage points in that span, to 73.7%.

Daniel Indiviglio follows up it with an in-depth comparison to Florida, while Tim Duy goes through the article and ends with this fantastic note: “according to the article, the ‘pitfalls’ amount to: Informed consumers, fewer foreclosures, healthier banks, higher rates of homeownership, and virtually no impact on average growth. Those are some ‘pitfalls’ – truly, greater consumer financial protection would spell ruin for us all.” Ha!

Two additional things:

Prepayment Penalties To go back to an old soapbox of mine, it’s worth noting that Vermont has outlawed prepayment penalties. Why is this important? My own thoughts, and the research is finding this as well, is that “lenders designed subprime mortgages as bridge-financing to the borrower over short horizons for mutual benefit from house price appreciation...Subprime mortgages were meant to be rolled over and each time the horizon deliberately kept short to limit the lender’s exposure to high-risk borrowers.” The prepayment penalty is what made these bad-faith loans profitable to the lenders, and with house prices increasing, prepayment penalties allowed lenders to bet directly on this housing appreciation.

To put it a different way, banks, instead of underwriting borrowers, were betting that house prices would increase, and paying consumers to sit in the houses. The fees and prepayment penalties were the payout that made this bet profitable (with that consumer getting what’s left over in housing appreciation). Banks don’t normally bet on house prices – they have exposures, but they are secondary exposures related to recoveries and risks – they bet on consumers. Getting rid of these prepayment penalties keeps them from taking that side bets. It also helps markets actually do their job, by allow borrowers to shop between outfits and products while reducing this transaction cost – and allow the innovation of interest rate risk management to make things a little easier for the consumer.
Texas  Like Vermont, Texas has some of the strictest mortgage regulations on the books. No prepayment penalties, no balloon mortgages, etc., and as a result of the Homestead Act of 1839 and subsequent laws strict rules on Home Equity Loans (pdf).

I mentioned earlier in the year, that these consumer protection laws may have played a major role in keeping Texas from having a major housing bubble. I did not know at the time that there was a study at the Dallas Federal Reserve, Why Texas Feels Less Subprime Stress than U.S., that also came to the same conclusion:

Due to the state’s strong predatory lending laws and restrictions on mortgage equity withdrawals, a smaller share of Texas’ subprime loans involve cash-out refinancing, which reduces homeowner equity and makes default more likely when mortgage payments become unaffordable....

State data on subprime mortgage delinquencies suggest that housing prices and local economic factors are still the primary drivers of subprime default rates. Even so, mortgage characteristics also matter—from the incidence of ARMs to the purpose for which the loan was taken out. In general, cash-out refinancing loans are more prone to delinquency than loans for outright purchases.

Recent tightening of credit standards in the mortgage market has put a lid on the growth of subprime and exotic mortgages. Nevertheless, a sharply deteriorating economy, weak home sales and a continued downward trend in housing prices suggest that delinquencies and foreclosures will continue at a high level.

I find it very ironic that places like the AEI are using Texas as the role model for The Way States Should Conduct Themselves in the future, which is by association bootstrap-tugging laissez-faire financial capitalism. The research produced at the Dallas’ Federal Reserve, by economists on the ground, points out the exact opposite – consumer protection is a major reason why Texas isn’t Arizona or California or Florida. Consumer protection allows a baseline of financial safety, a net where the work of building our real economy can take place.
Has Mortgage Modification failed?

Mike  |  20 Aug 2009

Obama’s mortgage modification plan, HAMP (Home Affordable Modification Program), isn’t working very well. Designed to help prevent foreclosures by incentivizing and giving legal protection to previously indifferent middle-men servicers it isn’t producing anywhere near the number of modifications that were anticipated. Is it likely to work in the future? My guess is no. Let’s discuss some reasons why.

Servicers Gaming the System Over the past few months, more and more stories have come out about servicers finding ways to line their pockets while consumers and investors are getting shortchanged. The one that brought the gaming issue to everyone’s attention is Peter Goodman’s article in the New York Times. Here are my favorite three since then:

Story One, Financial Times:

JPMorgan Chase, one of the first mega banks to champion the national home loan modification effort, has struck a sour chord with some investors over the risk of moral hazard posed by certain loan modifications.

Chase Mortgage, as servicer of several Washington Mutual option ARM securitizations it inherited last year in acquiring WAMU, has in several cases modified borrower loan payments to a rate that essentially equals its unusually high servicing fee, according to an analysis by Debtwire ABS. Simultaneously, Chase is cutting off the cash flow to the trust that owns the mortgage. In some cases, Chase is collecting more than half of a borrower’s monthly payment as its fee.

Story Two, Credit Slips

Countrywide Home Loans (which is now part of Bank of America) has been the subject of proceedings in several bankruptcy courts because of the shoddy recordkeeping behind their claims in bankruptcy cases. Judge Marilyn Shea-Stonum of the U.S. Bankruptcy Court for the Northern District of Ohio recently sanctioned Countrywide for its conduct in these cases...The resulting opinion makes extensive reference to Credit Slips regular blogger Katie Porter and guest blogger Tara
Twomey’s excellent Mortgage Study that documented the extent to which bankruptcy claims by mortgage servicers were often erroneous and not supported by evidence. Specifically, the court adopted Porter’s recommendation from a Texas Law Review article that mortgage servicers should disclose the amounts they are owed based on a standard form. Judge Shea-Stonum found that such a requirement would prevent future misconduct by Countrywide.

Mary Kane, Washington Independent

Even as the Obama administration presses the lending industry to get more mortgage loans modified, the practice of forcing borrowers to sign away their legal rights in order to get their loans reworked is a tactic that some servicers just won’t give up on...

In a dramatic confrontation last July, Rep. Barney Frank (D-Mass.), chairman of the House Financial Services Committee, told representatives of Bank of America to get rid of waivers in their agreements. His pronouncement came after Bank of America representatives denied they were using the waivers – and Julia Gordon, senior policy counsel at the Center for Responsible Lending, produced one from her briefcase.

Check out those stories. The first has the servicers set the payment to maximize their fees, and not anything beyond (to make sure very poor and desperate mortgage holders are able to pay each month), making sure their interests are above the lender’s ones. The second one shows that it is very difficult to determine incompetence from maliciousness with the way that servicers are handling their documents on the borrowers end. And the third would be a great piece of classic comedy if it wasn’t so terrible. I bet these guys sleep like babies at night too.

The servicer’s interests are their own – and if they can rent-seek at the expense of the parties at either end, ‘nudging’ them with $1,000 isn’t going to make a big difference.

Redefault Risk There’s another story where the servicers aren’t modifying loans because it isn’t profitable for the lenders. There’s a very influential Boston Federal Reserve paper by Manuel Adelino, Kristopher Gerardi, and Paul S. Willen titled “Why Don’t Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization.” They
point out that, according to their regressions, redefault risk is very high – the chances that even under a modification there will still be a foreclosures, so why not foreclosure immediately?

I’d recommend Levitin’s critique (Part 1, Part 2), notably that the securitization regression doesn’t control for type of modification, specifically they don’t variable whether or not the modification involved principal reduction, which is probably does for the on-book loans and not for the off-book loans.

But regardless, this is a valid argument as U3 unemployment starts its final march to 10% we are going to see consumers become riskier and riskier, and that will be a problem for modification that will get worse before it gets better.

**General Inexperience** Servicers were never designed to do this kind of work; they don’t underwrite, and paying them $1,000 isn’t going to give them the experience needed for underwriting. It’s hard work that requires experience and dedication, skills that we don’t have currently. (Isn’t it amazing with the amount of money we’ve put into the real estate finance sector over the past decade we have a giant labor surplus of people who can bundle mortgages into bonds but nobody who can actually underwrite a mortgages well?)

But isn’t it at least possible that as the sophistication of the servicers increase, they’ll become equally good at learning how to game the system? I don’t mean this as a gotcha point, because I think it is the fundamental problem here, and there isn’t any way to break it. The servicers get paid when they have to get involved, and learning the contracts better will give them more reasons to get involved.

It’s been know for several years now that this was a weak spot in the mortgage backed security instruments. In the words of the creator of this instrument, Lewis Ranieri in 2008: “The problem now with the size of securitization and so many loans are not in the hands of a portfolio lender but in a security where structurally nobody is acting as the fiduciary. And part of our dilemma here is ‘who is going to make the decision on how to restructure around a credible borrower and is anybody paying that person to make that decision?’ … have to cut the gordian knot of the securitization of these loans because otherwise if we keep letting these things go into foreclosure it’s a feedback loop where it will ultimately crush the consumer economy.”

He’s right of course; the people we are trying to ‘nudge’ into acting as the fiduciary are going to be more than happy to rent-seek these
instruments while they crush the consumer economy. This ‘gordian knot’ has to be broken, but it’ll need to be done outside the instruments – in the bankruptcy court.
Dean Baker’s Right To Rent

Mike | 20 Aug 2009

There’s another problem with trying to deal with the foreclosure problem – the most obvious solution, mortgage cramdowns, are very unpopular. They failed to pass last spring, and are probably even less likely to pass now. People don’t like thinking that they are rewarding those who made bad mortgage decisions. Very few people have ever come close to trading a credit default swap – every adult has had to make a choice about mortgages over the past 10 years, and rewarding, in the words of CNBC, “the losers” is a political no-go in the United States.

What is another choice? How about “Right To Rent”? Here’s Simon Johnson back in November of 2008 calling what would happen over the next 10 months and then suggesting a version of Right To Rent:

Washington is beginning to turn its attention to housing, and there is progress on plans to make it easier to modify delinquent mortgages where there is a win-win solution for the borrower and the lender.

At best, though, this is only a partial solution. Many homeowners will be unable to afford any mortgage that lenders will accept. Complicated relationships between servicers and secondary-market investors will make it difficult, impossible or illegal to restructure many mortgages...

In addition to limiting the number of foreclosures, it will be critical to manage the flow of foreclosed properties onto the market. Otherwise, the mounting wave of foreclosed condos and single-family homes threatens to push housing prices far below long-term sustainable levels, inflicting unneeded pain on homeowners and the economy.... Here are some ways to facilitate an orderly unwinding of real estate...

The borrower turns over the deed to the servicer and rents the property back from the mortgage investor for some period of time. At the end of the period, the renter can get a new mortgage from the investor at prevailing market rates if the borrower qualifies; if not, the property goes on the market.
I want to take that idea and flesh it out further. I think the best approach is the version suggested by Dean Baker’s, who also originated the idea, described here:

There is an easier route. In recognition of the extraordinary situation created by the housing bubble and its collapse, Congress could approve a temporary change to the rules governing the foreclosure process. This change would give homeowners facing foreclosure the right to stay in their homes, paying the market rent for a substantial period of time (eg seven to 10 years).

This change would have two effects. First, it would immediately give housing security to the millions of families facing foreclosure. If they like the house, the neighbourhood, the schools for their kids, they would have the option to remain there for a substantial period of time.

Also by keeping homes occupied, this rule change can help prevent the blight of foreclosures that has depressed property values in many areas. Vacant homes are often not maintained and can become havens for drug use and crime.

Dean Baker has had this proposal out there for a while, since at least 2007. Felix Salmon had it as one of his Fixing The World Ideas in The Atlantic Monthly. Some conservative economists, including Andrew Samwick have signed on, and there’s a version of a bill floating out there.

So what are the advantages? The foreclosure is avoided, keeping pressure off the community and not displacing a family. The rent is set by an appraiser to the neighborhood renting value, and reassessed whenever either the lender or borrower requests it at their cost. This prevents it from becoming a de facto form of rent control, while the externality effect of people losing the value of being able to sell their home because of foreclosures down the block has gone away, not to mention the more general social cost of abandoned housing.

Now is this a gift to those who made terrible decisions? No. As opposed to a normal foreclosure in most states, it is purposely designed so that any equity built up in the loan isn’t transferred over to the consumer. Normally if the bank sells your house for more than the loan outstanding plus fees in a foreclosure, you get the remainder. Not so with Right to Rent, the bank gets all that upside and the other party gets their equity wiped out.
Some versions of similar plans are designed so the bank is required to sell back to the renter first at a later date; I see no reason for this, as the bank will almost certainly offer it first to the people at the property if they can afford it. If they sell it to someone else however, the person still gets to rent their home. Personally I’d like to see the timeframe for the home rental to be on the order of 3-5 years, though that is debatable. Ideally it would also have accelerated eviction rules, so that people who couldn’t even afford the rent aren’t still living in said property.

This requires no taxpayer funding, and can be done in our very efficient bankruptcy courts. How great of a deal is that?

What are the downsides? It is an intrusion onto the property rights of the lender. The lender can still sell, but will sell with a tenant attached to the property. For the time being, the social costs being accumulated by neighborhoods as properties sit vacant is devastating, enough so that we need to take action. Lenders will become landlords, though there are a lot number of civic groups, third parties, businesses, etc. who can contract that labor out if it can’t be done in-house.

What are your critiques? Thoughts? Personally, in terms of our current political dialogue, I wonder if the type of social conservative who is willing to lock up large segments of the population to prevent a “broken window” from forming would be willing to ask a lender to take a small haircut to save the entire house from rotting in foreclosure, windows included. Nothing increases the “disorder” of a neighborhood than having foreclosed houses rotting away on them…
The Two-Track Economy

Simon Johnson | 20 Aug 2009

The quick way to talk about how any economy is doing is in terms of “growth”. This is just what it sounds – a measure of how much the total value of production in a country has increased in the last month, quarter, or year.

Thinking in terms of total production – more precisely, this is usually Gross Domestic Product, GDP – never tells you everything that you want to know, but it usually gives you a sense of the near term dynamics: are business prospects expanding or contracting; is unemployment going to rise further; and will people’s wages outpace or fall behind inflation?

Seen in these terms, the balance of opinion on the near term outlook for the U.S. today has definitely shifted towards being more positive. A number of prominent analysts have revised upwards their growth expectation for the second half of this year considerably – for example, the ever influential Goldman Sachs was recently expecting 1 percent growth (annualized), now they guess it will be closer to 3 percent.

“Potential” growth in the U.S. is generally considered to be between 2 and 3 percent per annum – this is how fast the economy can usually grow without causing inflation to increase. So the Goldman swing in opinion is equivalent to switching from saying the second half of this year will be “miserable” to saying there will be a fairly strong recovery.

But at this stage in our economic boom-bust cycle, is it still helpful to think in terms of one aggregate measure of output? Or are we seeing the emergence of a two-track economy: one bouncing back in a relatively healthy fashion, and the other really struggling?

Think about this in terms of individuals and the households in which they live. Some people have lost their jobs and are finding reemployment very difficult; many will exhaust their unemployment benefits soon. Others find that what they owe on their mortgages far exceeds the value of their home. And many find they have been cheated by financial products, particularly home loans and credit cards — which is why we need effective consumer protection for finance, and in a hurry.

The traditional U.S. recession remedy is: move to another, more prosperous part of the country. But nowhere is exactly booming at present. And how do you move if you can’t sell your house?
The overall numbers on outcomes by groups can get complicated (here’s a partial guide), but the simple version is: the top 10% of people are going to do fine, the middle of the income distribution have been hard hit by overborrowing, and poorer people will continue to struggle with unstable jobs and low wages.

Can the richest people spend enough to power a recovery in overall GDP? Perhaps, but is that really the kind of economy you want to live in?

The United States has, over the past two decades, started to take on characteristics more traditionally associated with Latin America: extreme income inequality, rising poverty levels, and worsening health conditions for many. The elite live well and seem not to mind repeated cycles of economic-financial crisis. In fact, if you want to be cynical, you might start to think that the most powerful of the well-to-do actually don’t lose much from a banking sector run amok – providing the government can afford to provide repeated bailouts (paid for presumably through various impositions on people outside the uppermost elite strata).

Ultimately, of course, you get lower growth. But by the time that is clear in the numbers, it may be too late to do much about it.

By Simon Johnson

This post originally appeared on the NYT’s Economix blog, and it is used here with permission. If you wish to reproduce the entire post, please contact the New York Times. The usual fair use rules apply to short quotations.
The Limits of Arbitrage

Mike | 21 Aug 2009

Wow, it’s already Friday. I’ll feel that I’ve short-changed you if we don’t do some Finance Theory before I go.

Did you see this roundtable about the state of macroeconomics in The Economist’s Free Exchange? Fascinating stuff; in particular it became a bit of an odd defense of the Efficient Markets Hypothesis (EMH). A representative comment was made by William Easterly, in defense of EMH:

The most important part of the much-maligned Efficient Markets Hypothesis (EMH) is that nobody can systematically beat the stock market. Which implies nobody can predict a market crash, because if you could, then you would obviously beat the market. This applies also to other asset markets like housing prices.

This is not true, and I want us to walk through why it isn’t. In March of 1997, Andrei Shleifer and Robert Vishny published a paper titled The Limits of Arbitrage (pdf) in the Journal of Finance. I think it’s the most important finance paper of the past 15 years, something everyone even remotely connected to financial markets should become familiar with. It builds on and summarizes a decade long research project, research they conducted with people such as Joseph Lakonishok and Brad DeLong. In it they say that arbitrageurs, the very smart and talented traders at hedge funds who will take prices that are out of line and bring them back into line, making a good fee and making prices reflect all available information, the very building block necessary for EMH to work, can’t do their job if they are time or credit constrained. Specifically, if they are highly leveraged, and prices move against their position before they return to their fundamental value – if the market stays irrational longer than they can remain solvent – they’ll collapse before they can do their job.

And sure enough, a year later in 1998, Long Term Capital Management, very smart highly leveraged arbitrageurs, found themselves in a situation where prices moved away from them, and they had no capital with which to keep themselves afloat, just like Limits Of Arbitrage predicted. (This is the standard narrative in finance research seminars; it
also appears this way, correctly, in Justin Fox’s *The Myth of the Rational Market*, a very excellent book that gets these details correct.)

There’s an argument that says “If the market is inefficient, why aren’t you rich?” This gives us the framework to understand why markets could deviate from true value but there isn’t a way to capitalize on bringing them back to true value – sometimes there is risk inherent in arbitrage, and sometimes there are situations where it is difficult to get on the other side of a trade. And specifically, it’s risk that isn’t compensated.

Here’s an example of how this works. Let’s say something is trading at $5. You are **positive** it is going to reach $10. Positive. It must. No chance it won’t at some point in the future. So you buy it, telling your boss/manager/investors you are going to make $10-$5 = $5 for free. But the price goes to $2.50. What happens? You **should buy a lot more**. Now you are going to make $7.50! However your boss/manager/investor thinks you are insane and have lost them all kinds of money, as they now have half of what they gave you, and wants to pull your trading funds – if you sell then, you lose money, and put downward pressure on the price. Also, depending on how you were leveraged, you may also be bankrupt. That’s how this works.

This gives us a guideline for figuring out how markets can get out of alignment with value – if it is difficult to attract arbitrageurs, who are necessary to keep prices in alignment, we should expect the market to have prices that are more prone to manipulation and bubbles. What attracts arbitrageurs? The bond market – it is easy to calculate the value of a bond, and easy to realize the value quickly. Foreign exchange markets – it’s relatively easy for arbitrageurs to go after central banks attempts to maintain nonmarket exchange rates.

What doesn’t attract arbitrageurs as easily? The stock market. The absolute and relative value of a stock is harder to estimate, and it may take a long period of time to realize your gain. (If you are comfortable with the terms, expected alpha doesn’t increase in proportion to volatility if volatility includes fundamental risk – read the paper, it’s excellent!) And though it isn’t covered in the paper, housing.

There’s no real way to go short housing. You can go short the bank issuing mortgages, but if the bank has two internal businesses – jumbo subprime loans and boring small business loans – might it not be sensible for them to turn down the business loan division in response to the market shorting? You need to be able to exert price pressure directly
onto the market itself – the more intermediaries, the more likely it is your signal is converted into noise. There’s talk about how in the future we’ll all trade derivatives contracts on each other’s neighborhoods; depending on how that’s implemented, it would be something to say “I want to go short Detroit and Peoria in my portfolio.” Is there moral hazard to drive down those prices then? And life would be more interesting if the investment firm of “My Ex-Girlfriends LLC” could take out a derivative insurance contract that pays out to them if my house burns down over the next year. Thankfully that market is still some time away, if it ever gets here, so we can iron out the difficulties.

There’s a lot more research to be done here, but contrary to popular belief we do have an intellectual framework to know how markets can get out of whack, one that takes the EMH are brings it to a reality where we face actual constraints over scarce resources such as time and capital.
The Best of Behavioral Finance Anomalies

Mike | 21 Aug 2009

And before I go, my two favorite Behavioral Finance anomalies. Learn them, because next time someone tells you that the market is perfectly efficient all the time, bring these up.


This paper investigates the response of option market investors to the information contained in daily changes in the instantaneous variance of the underlying asset. Evidence is provided that these investors exhibit (1) short-horizon underreaction to daily information, (2) long-horizon overreaction to extended periods of mostly similar daily information, and (3) increasing misreaction (along a scale that ascends from underreaction to overreaction) to daily information as a function of the quantity of previous similar information. The increasing misreaction can reconcile the short-horizon underreaction with the long-horizon overreaction and is also consistent with well-established cognitive biases.

The behavioral cues related to overreaction and underreaction that we know show up in the stock market also show up in the options market. Why is this important? Because as opposed to the stock market, option traders are looking at one variable, the volatility, and trying to estimate it. Instead of a mix of P/E ratios and the whole mess of problems with equity valuation, options have one free variable, the volatility, and options traders have the same behavioral cues when they estimate it.

Also the market is dominated by professional investors. This isn’t the “I heard on the television to buy” crowd. These are people who know the market, and know that there are behavioral cues. Also the market is highly liquid, which removes one of those problems in trying to figure out if behavioral ticks in equities markets are the result of market imperfections.

So isolated down, to a professional, highly-paid investor in a highly liquid market looking at one single variable – volatility – we still see behavioral over/under-reaction. Score that for the behavioral crew.
How do investors respond to predictable shifts in profitability? We consider how demographic shifts affect profits and returns across industries. Cohort size fluctuations produce forecastable demand changes for age-sensitive sectors, such as toys, bicycles, beer, life insurance, and nursing homes. These demand changes are predictable once a specific cohort is born. We use lagged consumption and demographic data to forecast future consumption demand growth induced by changes in age structure. We find that demand forecasts predict profitability by industry. Moreover, forecast demand changes five to ten years in the future predict annual industry stock returns. One additional percentage point of annualized demand growth due to demographics predicts a 5 to 10 percentage point increase in annual abnormal industry stock returns. However, forecasted demand changes over shorter horizons do not predict stock returns. A trading strategy exploiting demographic information earns an annualized risk-adjusted return of approximately 6 percent. We present a model of inattention to information about the distant future that is consistent with the findings. We also discuss alternative explanations, including omitted risk-based factors.

So what’s going on here? If you ask financial analysts, they may tell you that they are trying to get it right 3 to 5 years out. If you ask a EMH guy, they’d say that’s impossible, markets have to be correct for all time, since they reflect all available information. So if there was going to be a predictable demand for a good 10 years out, the market should have already priced that.

How do we test that? In this paper, DellaVigna and Pollet took on the Herculean statistical task of looking at demographic groups as they age, using birth rates and life expectancy rates, and comparing that with predicted demand for goods/services across years, and see when the market realizes that these groups are going to start consuming toys for their children, nursing homes for the elderly, etc. They found that the market gets this right, but only about 3 to 5 years out. Past that point, the market ignores it.
Why? People and institutions have time and attention constraints. Perhaps people also don’t want to get rewarded for something that won’t happen for 10 years, when they may be at another job (or already denied the promotion that occurs every 3 years).

The problem is that things that may not happen for another 6 years are off the radar – there’s more immediate important and profitable stuff to deal with in the here and now. 6 years is a terribly long time in the finance world to sit and wait to weed out inefficiencies (there are limits to arbitrage!), though if they involve huge risks, say a nation-wide housing bubble, it isn’t clear that the market will be able to think through the effect of their actions 10 years down the line.

So check them out – both fantastic papers. What are you favorites?
One Last Thought on FDIC and Political Will

Mike | 21 Aug 2009

So this is Mike Konczal signing off for the week – I’d like to thank James and Simon for giving me the opportunity to guest-blog here. And I’d like to thank all the readers and commenters for sparking discussions and refining my thoughts about many of the issues here.

You can follow my blogging at the rortybomb blog, and I’m also on twitter.

I want to close on one last note about where we, as a country, need to go from here. As a longtime fan of The Baseline Scenario, I read that there’s a project here to show the way in which capture by the financial industry has taken place in this country; through regulatory capture, through social networks and connections, etc.

There’s another element to it as well, and that’s what we as a country expect our government to be able to do about it. I want to point out this netroots nation video of Chris Hayes, an editor at The Nation, talking about The New Deal versus today (5m20s start):

Think about FDIC, how would we design FDIC today?...What we would do is, we wouldn’t set up an independent government agency which works very well, has worked smoothly, has prevented bank runs, since the bad old days of bank runs...we wouldn’t do that today. The banks would be like ‘what? you are just going to step into this market?’ What we’d do today if we were designing FDIC is we’d choose a bunch of the banks and we’d subsidize them insuring other banks...

The Home Ownership Loan Corporation...we have a lot of foreclosures, a lot of people underwater on mortgages. What are we doing? We are subsidizing the lenders with public dollars and telling them ‘if we give you guys some money, will you go help those people?’ And surprise, surprise, they have not really gotten their asses to do it. Now the Home Ownership Loan Corporation was faced with the same exact problem...and it went out and bought the mortgages and directly re-negotiated the terms of the mortgages, and it was very, very successful.

This is a massive conceptual problem.
I find this fascinating because I completely agree that, if we were to encounter bank runs for the first time today, this is how we’d try to set up FDIC. FDIC is an example of a government program that works, and the banks-insuring-one-another-with-public-money is exactly the kind of operation we’d expect to fail. I also find it fascinating because I believe part of what happened in this crisis is that we started a banking system in the capital markets, a ‘shadow bank system’ if you will, that collapsed in a new 21st century style bank run, and going forward we need to find a way to regulate it properly to make sure it doesn’t happen again (here’s interview I did with Perry Mehrling about it).

It’s one thing to identify the problem – finding the will to conceptualize the problems, and begin to fix them, is the other half of the solving the problem. And that is what this country needs more of, less hoping that the problems will fix themselves if we shove enough public money to private parties, and more of working to find the solutions ourselves.

Thanks for the great week all!
More by Arindrajit Dube

James Kwak  |  24 Aug 2009

Last month Arindrajit Dube wrote a guest post for us analyzing private insurer stock market returns following the news that the Senate Finance Committee “Group of Six” would be dropping the public plan; he estimated that avoiding a public plan would be worth $28-35 billion to three major insurers. Last week he did a similar analysis based on last Sunday’s comments by Kathleen Sebelius and Robert Gibbs indicating potential willingness to drop the public plan (something the administration has tentatively backpedaled from). I was on vacation, but his analysis is available on Economist’s View, and his bottom-line number is $32 billion, or 40% of their market value.

Dube also co-authored an op-ed in The New York Times on San Francisco’s experience with comprehensive, government-mandated health insurance. One of their points is that in an environment where all competitors are forced to pay something for health insurance, this creates a level playing field where all companies can pass on the higher costs to consumers – as opposed to a situation where companies race to the bottom by cutting benefits in order to minimize costs.

By James Kwak
Fun with Derivatives

James Kwak | 24 Aug 2009

Fresh off my vacation, I have jury duty tomorrow, but today I got a jump on my fun reading for the courthouse – *Traders, Guns, & Money*, the anecdote-packed overview of derivatives by Satyajit Das, a prolific consultant, author, and commentator on the topic. Das says that his book “does not attempt to make a case for and against derivatives” (p. xiii), and it’s true that he does point out some of the useful, value-creating functions of derivatives. But this passage (p. 41) is probably more typical, and one I thought deserved being typed out:

We needed ‘innovation’, we were told. We created increasingly odd products. These obscure structures allowed us to earn higher margins than the cutthroat vanilla business. The structured business also provided flow for our trading desks. The more complex products were stripped down into simpler components that traders hedged. …

New structures that clients actually wanted were not that easy to create. Even if somebody came up with something, everybody learned about it almost instantaneously. They reverse-engineered the structure and then launched identical products.

In Das’s account, derivatives can be used to unbundle risk – but market competition makes unbundled risks look an awful lot like commodities. So the answer instead is bundle those risks back together into complex products that (a) customers can’t understand and (b) can earn high margins, at least temporarily. Das concludes his tutorial on inverse floaters this way (p. 50): “Greenspan had been right – risk had truly been unbundled. We had just packaged it right back up and shoved it down the eager throats of the wealthy taxpayers of Orange County.”

Which brings me back to something Mike Konczal (last week’s guest blogger – as my daughter would say, “Round of applause!”) discussed a while back – why do so many “innovative” financial products included *embedded options*? In Mike’s words, “When I was discussing this prepayment penalty theory with a very smart person from a hedge fund, he told me that selling people embedded options is always deviously clever because people don’t understand that they are buying them, and often don’t understand their value.” That sounds to me like the same thing Das is saying.
Change or More of the Same?

James Kwak | 24 Aug 2009

Matt Yglesias’s comments on James Surowiecki on the health care reform debate triggered a few thoughts in my head.

First, Surowiecki (after describing how people fear reform because they tend to fear change):

Because it’s hard for individuals to get affordable health insurance, and most people are insured through work, keeping your insurance means keeping your job. But in today’s economy there’s obviously no guarantee that you can do that. On top of that, even if you have insurance there’s a small but meaningful chance that when you actually get sick you’ll find out that your insurance doesn’t cover what you thought it did (in the case of what’s called “rescission”). In other words, the endowment that insured people want to hold on to is much shakier than it appears. Changing the system so that individuals can get affordable health care, while banning bad behavior on the part of insurance companies, will actually make it more likely, not less, that people will get to preserve their current level of coverage.

This is basically what Simon and I argued in the Washington Post a couple weeks ago, and I’m glad that someone with a much bigger platform is saying it, too.

Surowiecki goes on, “The message, in other words, should be: if we want to protect the status quo, we need to reform it.” This reflects a disturbing trend I’ve been seeing lately, and that to a small extent I’ve participated in: supporters of health care reform talking about how the Obama Administration is fumbling the message. George Lakoff’s recent assault on “PolicySpeak” is one example. (I generally find Lakoff only half-convincing; I read Moral Politics, and while I thought his characterization of the conservative model was brilliant, I thought his attempt to create a liberal “equivalent” was an exercise in wishful thinking. I think conservatives just have it easier when it comes to this sort of thing.)

I don’t mean that Surowiecki shouldn’t be criticizing the messaging; I mean that it’s worrying that the administration’s communications problems have become the news – in part, of course, because the media
find them more “newsworthy” than, say, the details of non-profit cooperatives. Remember, this was the team that ran the most praised presidential campaign in decades. If they can’t get it right, maybe the problem goes deeper.

And here’s Yglesias:

Insofar as people are already walking around filled with anxiety about loss of employer-provided coverage or rescission, then this kind of message will appeal to them. But if you run around trying to tell people they don’t have things as good as they think you do, will they embrace your policies or just decide you’re an unpleasant jerk?

According to the polls, many people are not walking around filled with anxiety. I guess I’m the unpleasant jerk in this scenario; our Post column was titled “Like Your Health Insurance? Maybe You Shouldn’t,” after all. My theory is that the only thing you can use to counter fear is fear; instead of being afraid of government death panels that don’t exist and won’t exist, people should fear losing their jobs and getting sick, which are real dangers. But curiously, we Americans seem to have this instinctive belief that we must have it good – we’re Americans, for God’s sake. And if that’s the case, then change – especially change that brings us marginally closer to the way every other advanced country provides health insurance – must be something to be afraid of.

Update: Mark Thoma makes a similar point:

The point that Democrats must make clear is that doing nothing puts people’s existing health care coverage at substantial risk. People should be very afraid if reform fails, especially people who have good coverage now since they’re the ones with the most to lose. . . . System-wide reform of health care is the best chance people have for a health care system that meets their needs at least as well as what they have now, and the necessary reform cannot be accomplished without government’s help.

By James Kwak
Which Bernanke? Whose Bubble?

Simon Johnson  | 25 Aug 2009

Ben Bernanke will be nominated for a second term as chairman of the Federal Reserve. But which Bernanke are we getting? There are at least three.

1. The Bernanke who led the charge to rescue the US (and world’s) financial system after the Lehman-AIG collapse. If you accept that the choice from late September was “Collapse or Rescue,” this Bernanke did a great job.

2. The Bernanke who argued for keeping interest rates low as the housing bubble developed. This Bernanke was part of the Greenspan Illusion – the Fed should ignore bubbles and “just clean up afterwards.” Is that still Bernanke’s view? Surely, he has learned from that experience.

3. Then there is Bernanke-the-reformer. Given #1 and #2 above, shouldn’t he be pushing hard for tough re-regulation of the financial system – particularly those dodgy parts where markets meet banking? But is there any sign of such an agenda, even with regard to recently trampled consumers – let alone “too big to fail” financial institutions?

Most likely, we’re in for another bubble.

The Fed will keep interest rates low for the foreseeable future. This will make sense given continued high rates of unemployment in the US economy. But unemployment indicates average economic outcomes – high unemployment is completely consistent with some parts of the financial sector expanding at record rates: this is part of the two-track story.

The big banks have access to large amounts of Fed-provided funding at very low rates. We’ll see this reflected in speculative market activities (think oil).

We’ll also see this in global capital flows (i.e., gross flows, perhaps also net flows – but the new global imbalances may not be so obvious in the pattern of current account surpluses/deficits around the world). The US is increasingly a cheap funding environment, if you are a big player (definition: anyone regarded as an important client by Goldman). Rates now begin to rise in emerging markets, as their economies turn around. The Asia story will be compelling fundamentals and a great carry trade (borrow cheaply in dollars, lend at higher rates in Asian
currencies) - and the exchange rate risk is for appreciation against the dollar.

Everyone involved knows this is unsustainable, but also that it can last for a while – and they can get out before everyone else. Or, alternatively, that – as major financial players – they can’t afford to sit on the sidelines (talk to Chuck Prince: what has changed, in ideology, policies, and people at the top since his day?).

Presumably, commodity prices also get dragged up – or perhaps they jump up in anticipation of the Coming Asian Boom? Now this might lead Asian central banks to tighten, but probably not if these economies can continue to keep wage costs under control. And it might lead the Fed to tighten, but probably not as the mantra of focusing on “core inflation” (without food and energy prices) remains intact – however anachronistic it may seem to the rest of us. It’s hard to see Bernanke #2 doing anything different, except perhaps at inconsequential margins.

So then we really bubble – and perhaps we even mistake it for a boom.

When the Big Crash comes, there’ll be another moment of decision: “Collapse or Rescue.” And we know what Bernanke #1 will do. Which is, of course, why this administration is reappointing him – and not seriously reregulating big finance.

By Simon Johnson
Medicare and the Public Option

James Kwak | 25 Aug 2009

Simon and I have our latest weekly column up at the Washington Post. The topic is contradictions: opponents of the public option who bill themselves as defenders of Medicare, opponents of cost savings who support private health insurers, and so on. It’s also about a world without a public option:

Imagine health-care reform without a public option: Insurers have to charge the same price regardless of customers’ medical history; everyone has to buy insurance; and poor people get subsidies to help them afford it. From the insurers’ perspective, they get more than 40 million new customers, they subsidize the old and sick by overcharging the young and healthy (who have to overpay because of the mandate), and the government even pays people to buy their product. There are no new competitors (additional choices for customers), and there is no pressure to reduce costs. What could be better?

As we’ve said before, I think this is still far better than the current situation. Ezra Klein recently made the point much more forcefully. But still, reform without the public option could be a recipe for private insurers to charge whatever they feel like charging. Alex Tabarrok, not the first person you would expect to write a post called “In Defense of the Public Option,” writes:

Since escape via non-purchase will no longer be a potential response to higher prices, mandatory purchase will reduce the elasticity of demand giving firms an incentive to increase prices. Moreover, in oligopolistic markets, a more homogeneous product can increase the ability of firms to collude.

I believe that health insurance reform will increase the market power of insurance firms and drive up prices. In this scenario, the public option at least has a raison d’etre, although whether it actually fulfills it’s purpose is an open question.

By James Kwak
Chat Today About Bernanke Nomination For Reappointment (1pm Eastern)

Simon Johnson | 25 Aug 2009

The Washington Post is hosting an on-line chat about Ben Bernanke and his likely reappointment as chairman of the Federal Reserve Board of Governors (today, 1pm eastern: use this link to chat). News story on President Obama’s announcement of Bernanke’s renomination this morning, with video of press conference, is here.

You can submit questions in advance or live during the chat, which will probably run until about 2pm.

By Simon Johnson

Update: here’s the transcript of the chat; a lot of very good questions.
A Sad Day

James Kwak | 26 Aug 2009

I have nothing new or insightful to add, but it feels wrong to go back to blogging without paying respects to Ted Kennedy. When I was younger and perhaps more idealistic, I used to carry around a copy of his speech at the 1980 Democratic National Convention. He was a man who cared about the poor, the unemployed, and the sick, even as their cause became less and less fashionable over the past four decades. He believed that justice went beyond formalistic legal rights and extended to economic and social conditions as well. The Senate needs another person like him, but sadly will not find one.

By James Kwak
Larry Summers on Preventing and Fighting Financial Crises

James Kwak  | 26 Aug 2009

This fall I am taking a course on the “international financial crisis” taught by Jon Macey and Greg Fleming (yes, the former COO of Merrill Lynch). The first assigned reading is a speech that Larry Summers gave at the AEA in 2000 entitled “International Financial Crises: Causes, Prevention, and Cures,” summarizing the state of the art in preventing and combating financial crises. It’s based on experiences from emerging market crises in the 1990s, and doesn’t even contain a hint that something similar might happen here; however, few people could fault Summers for making that oversight back in 2000, and I certainly won’t.

Many people, including Simon and me, have discussed the similarities between our recent financial crisis and the emerging market crises of the 1990s, so I’ll be brief. The main similarities are excessive optimism that creates an asset price bubble, a sudden collapse of confidence that causes the rapid withdrawal of money and credit, a liquidity crunch, and rapid de-leveraging that threatens solvency. (We have also argued that there are political similarities, but let’s leave that aside for now.) The biggest difference is that instead of being compounded by flight from the affected country’s currency and government debt, in our case the exact opposite happened; investors fled toward the U.S. dollar and Treasuries, making things easier for us than for, say, Thailand. Also, to a partial extent, the parallel requires an analogy between emerging market countries and United States banks; for example, the issue of bailouts and moral hazard arises in the context of the IMF bailing out Indonesia and in the context of the United States government bailing out Citigroup.

Summers’s speech makes a lot of sense, so I’ll just highlight a few points he makes that I think are particularly instructive given our recent experience. I think these are all excellent points. For each one, I’ll quote from Summers, and then comment on its relevance to our situation.

1. Financial crises result from fundamental problems that should be fixed.

“It seems difficult to point to any emerging-market economy that experienced a financial crisis but did not have significant fundamental weaknesses that called into question the sustainability of its policies.”
“Bank runs or their international analogues are not driven by sunspots: their likelihood is driven and determined by the extent of fundamental weaknesses. ... Preventing crises is heavily an issue of avoiding situations where the bank-run psychology takes hold, and that will depend heavily on strengthening core institutions and other fundamentals.”

In other words, you can’t blame a crisis entirely on investor psychology; there is something rotten. The panic of September-March was not, as some argued, simply a liquidity crisis; the premise of the liquidity crisis theory is that the fundamentals are sound (institutions are solvent), and Summers doesn’t believe that.

2. The strength of domestic financial systems and institutions matters more than aggregates such as the amount of debt.

“When well-capitalized and supervised banks, effective corporate governance and bankruptcy codes, and credible means of contract enforcement, along with other elements of a strong financial system, are present, significant amounts of debt will be sustainable. In their absence, even very small amounts of debt can be problematic.”**

The fact that U.S. consumers and banks had a lot of debt isn’t itself a cause of anything; if our financial system were effectively governed, debt alone would not have brought it down as spectacularly as it did.

3. Short-term funding is dangerous because it can be difficult to roll over in a crisis.

“Policy biases toward short-term capital need to be avoided.”

“A measure of sound management of short-term flows is implicit in any prudential regulation of banks.”

The U.S. failed on this count. A large portion of the shadow banking system – SIVs and SPVs raising short-term funds and investing them in long-term assets – was entirely dependent on short-term capital. It also turned out that most of the large corporate sector was dependent on commercial paper, which is also short-term. When short-term funding vanished in September, everyone was stuck.

4. Transparency matters.
“If one were writing a history of the American capital market, I think one would conclude that the single most important innovation shaping that market was the idea of generally accepted accounting principles. The transparency implicit in the generally accepted accounting principles (GAAP) promotes efficient market responses to change, and it supports stability. Furthermore, if as Ken Galbraith has observed, conscience is the fear that someone may be watching, it may be the single most effective means of promoting self-regulation.”

I think Summers is right on a historical scale – standard accounting conventions promote transparency. But looking only at the last two decades, I think that GAAP did not keep up with the realities of financial innovation, for example in accounting for SIVs. For the beneficial effect cited by Summers to hold – accounting standardization promotes effective self-regulation – the accounting has to accurately reflect the true risk being taken by institutions. If not, the causal chain breaks down.

5. Expectations of bailouts are bad.

“While conditioned, precautionary financial support is constructive in some cases, the risk inherent in systematic availability of unconditional credit to countries can be summarized in two words: moral hazard.”

“It is certain that a healthy financial system cannot be built on the expectation of bailouts.”

Enough said.

6. Rapid intervention in unhealthy institutions is critical.

“Prompt action needs to be taken to maintain financial stability, by moving quickly to support healthy institutions and by intervening in unhealthy institutions. The loss of confidence in the financial system and episodes of bank panics were not caused by early and necessary interventions in insolvent institutions. Rather, these problems were exacerbated by (a) a delay in intervening to address the problem of mounting nonperforming loans; (b) implicit bailout guarantees that led to an attempt to “gamble for redemption”; (c) a system of implicit, rather than explicit and incentive-compatible, deposit guarantees at a time when there was not a credible amount of fiscal resources.
available to back such guarantees; and (d) political distortions and interferences in the way interventions were carried out.”

Again leaving aside (d), I think our government was guilty of (a), (b), and maybe (c) in the recent crisis. It’s not clear that (a) has yet been satisfactorily addressed (even PPIP seems to be evaporating), especially when it comes to commercial real estate, and we clearly have (b). As for (c), we did move to explicit deposit guarantees, but we still have implicit guarantees on other bank funding (bonds); and though the government probably has a credible amount of fiscal resources, there is still the question of whether Congress or the Fed will come up with the money in a pinch.

So again, I think the Summers of 2000 was basically spot-on. However, I think the Obama Administration – of which Summers, of course, is a central figure – is doing a spotty job of implementing his lessons. Most notably, we have increased the expectation of bailouts by supporting unhealthy institutions, increasing moral hazard; and we have left the problem of toxic assets largely untouched, hoping that economic recovery will make it go away. I think this has been due largely to political realities, not to any failing of Larry Summers to understand his own thinking; the United States government has a lot more power negotiating with itself than an emerging market country has negotiating with the IMF.

The big current question is whether financial regulatory reform will fix the underlying problems that, according to the Summers, are the root of financial crises. For example, according to Summers (2000), we want a regime that discourages dependence on short-term funding, we want more transparency, and we want something that reduces rather than increases expectations of bailouts. Whether we get that – or whether the administration prefers to let regulatory reform fade away in the wake of the health care war – is the remaining test.

* The official online home of that paper doesn’t allow free downloads, so I don’t think I should post my copy, although other people may have.

** Citing a paper by Simon, Peter, Alastair Breach, and Eric Friedman!!

By James Kwak
Comments on the Health Care Debate

James Kwak | 26 Aug 2009

Last week, Mike Konczal got a little grief for saying that we have “the smartest comments section on the nets,” and while I’m not sure that’s literally true, I am frequently astounded at the quality of many of our comments. Instead of writing more on health care for today, I want to point you to a few comment threads on my previous post, “Medicare and the Public Option.”

1. StatsGuy on why the current reform proposals will subsidize and therefore increase overtreatment and drive up costs (which alone is worth the price of admission).

2. Russ and others on why nothing at all is better than reform without a public option (I don’t agree with him, though).

3. Carson Gross, anne, and Frank Tobin on high-deductible plans and making consumers aware of costs (I don’t agree with Carson, either).

And many, many more …

Also, StatsGuy recommends this article on the incentives faced by physicians, as do I.

By James Kwak
A Perspective on Financial Innovation

James Kwak  |  26 Aug 2009

Simon and I have a new article, “Finance: Before the Next Meltdown,” in the Fall issue of Democracy: A Journal of Ideas on one of our favorite topics, financial innovation. (It’s part of a larger Democracy symposium on innovation in general, available online and on sale on September 15.) Instead of just sniping at specific innovations gone awry, we try to lay out a systemic explanation of why financial innovation is different from other forms of innovation, and how it should be evaluated. In particular, we argue that even though some financial innovation is good, more is not necessarily better.

Financial innovation has also been on the minds of the Planet Money crew recently. Their first episode was a little over the top, basically ascribing all of the benefits of capitalism to financial innovation (I guess this is technically true, since money is a financial innovation, but they make it sound like the joint-stock corporation was a necessary ingredient for all economic progress). But last week they had a panel with prominent bloggers Felix Salmon, Tyler Cowen, and our friend Mike Konczal. Obviously I agree most with Salmon, but I thought Cowen’s position as the “defender” of financial innovation was interesting. Basically he agreed that financial innovation can cause problems, but he first argued that the innovation in question (synthetic CDOs) was a response to bad regulation, and then argued that regulation was likely to cause more problems than it solved, and therefore our best bet is to let the free market sort it out and hope for the best.

By James Kwak
Firefighter Arson And Our Macroeconomic Policymakers

Simon Johnson  | 27 Aug 2009

Firefighter arson is a serious problem. The U.S. Fire Administration, part of Homeland Security, concluded in 2003, “A very small percentage of otherwise trustworthy firefighters cause the very flames they are dispatched to put out” (p.1). Illustrative and shocking anecdotes are on pp. 9-15 of that report, as well as here and here.

Macroeconomic policy making now has a similar issue to confront.

As the economy begins to stabilize and the financial system shows signs of recovery, accolades start to shower down on various officials, including most recently Ben Bernanke, who was rewarded this week with renomination – and almost certain confirmation – to a second term as chairman of the Federal Reserve Board of Governors.

Bernanke is widely seen as our financial firefighter in chief (BusinessWeek; USA Today) Similar terms are used to describe Treasury Secretary Tim Geithner and the entire gigantic financial rescue effort. Larry Summers, head of the White House National Economic Council and administration economic guru-at-large, is applauded as an “experienced crisis manager”, which amounts to the same thing in this context.

If any of this sounds familiar, you’re probably remembering the famous cover of Time magazine from November 1999, which depicted Alan Greenspan, Robert Rubin, and Summers as “The Committee To Save The World.” The idea then was that crises in Asia, Latin America, and Russia had spilled over to US financial markets, most notably in the near failure of Long Term Capital Management, but disaster had been averted by – essentially – the financial firefighting abilities of this troika.

But what if the financial crises in recent decades – you can add the dotcom bubble, the S&Ls fiasco, and various emerging market debt crises to our recent housing and banking disaster – is not a sequence of random unfortunate events, but rather the product of a dangerous financial system? Given that today’s firefighters also previously held responsibility for overseeing this system, both recently and as long ago as the early 1990s, this question is relevant – particularly as the very same team, in various combinations, repeatedly pronounced on the system’s fundamental soundness.

Some of today’s firefighters pushed hard for deregulation of derivatives markets in the 1990s, and this now proves to have been an
important cause of the crisis (Summers and others). Others had responsibility for the solvency of Wall Street over the past half decade, yet disguised all potential warnings in layers of impenetrable opaqueness (e.g., Geithner; see p.91 in David Wessel’s bestselling In Fed We Trust, Crown Business, 2009). Still others pronounced that there was no housing bubble exactly as things spiraled out of control and the potential costs to taxpayers rose (Bernanke and his colleagues at the Fed; again, pick up Wessel’s book, p.93 is among the most damaging).

No one is suggesting that our illustrious financial firefighters deliberately triggered a crisis. But, for over two decades, they and their close mentors oversaw the operation and development of a banking and securities system with profound instability hard wired into its DNA. Don’t take my word for it; review this speech by Summers in April 2009, or – in the light of what we know now – look at his talk on crises to the American Economic Association in 2000.

Perhaps that was all a legitimate mistake on their parts and they have now learned the right lessons. But how then do you explain their amazing reluctance to reform the financial system today?

President Obama said on Tuesday that Ben Bernanke helped avert a second Great Depression. That is a considerable achievement, but why then are this administration and the Federal Reserve proposing only minor adjustments in oversight and governance for the financial system that ran amok – producing “financial innovation” that harms consumers and destabilizes everything?

It makes no sense at all. Unless, of course, they are not afraid of future financial fires – despite the enormous fiscal cost (likely 40% of GDP from this round alone), the unemployment (heading to and lingering at 10%, by the administration’s own revised estimates), and the millions of people hammered hard by lender abuse, house price collapse, and job losses.

You may not like the implications, but keep in mind this advice: “To ignore the problem or suggest that it does not exist will only increase the damage caused by the arson firefighters involved, as well as destroy the morale of the other firefighters in their departments” (Minnesota Fire Chief, March/April 1995 issue, quoted on p.1 of above cited report).

By Simon Johnson

A slightly edited version of this post originally appeared on NYT.com’s Economix, and from that version you can link directly to the referenced pages in David Wessel’s book.
This post is reproduced here with permission. If you would like to use the entire post, please contact the New York Times. The usual fair use rules apply to short quotations.
How Much Does the Financial Sector Cost?

**James Kwak | 28 Aug 2009**

Benjamin Friedman, in the *Financial Times* (hat tip Yves Smith), questions the high cost (read: compensation) of our financial sector. But he does not simply say that huge bonuses for bankers are unfair. Instead, he says that the costs of financial services need to be balanced against their benefits.

The discussion of the costs associated with our financial system has mostly focused on the paper value of its recent mistakes and what taxpayers have had to put up to supply first aid. The estimated $4,000bn of losses in US mortgage-related securities are just the surface of the story. Beneath those losses are real economic costs due to wasted resources: mortgage mis-pricing led the US to build far too many houses. Similar pricing errors in the telecoms bubble a decade ago led to millions of miles of unused fibre-optic cable being laid.

The misused resources and the output foregone due to the recession are still part of the calculation of how (in)efficient our financial system is. What has somehow escaped attention is the cost of running the system.

In particular, Friedman wonders at the relationship between the value provided by financial services and the opportunity cost involved: “Perversely, the largest individual returns seem to flow to those whose job is to ensure that microscopically small deviations from observable regularities in asset price relationships persist for only one millisecond instead of three. These talented and energetic young citizens could surely be doing something more useful.”

This reminds me of something Felix Salmon wrote about a while back: If profits and compensation in the financial sector go up and keep going up, that’s a priori evidence of inefficiency, not efficiency. Those higher profits mean that customers are paying more for their financial services over time, not less, which means that financial services are imposing a larger and larger tax on the economy. Now, it is possible that they are also increasing in value fast enough to cover the tax, but that is something to be proven.

By James Kwak
Causes: Too Much Debt

James Kwak | 28 Aug 2009

Menzie Chinn, one of my favorite bloggers, and Jeffry Frieden have a short and highly readable article up on the causes of the financial crisis. Chinn is not given to ideological ranting and is a great believer in actually looking at data, so I place significant weight in what he says.

Chinn and Frieden place the emphasis on excessive American borrowing, by both the public and private sectors.

This disaster is, in our view, merely the most recent example of a “capital flow cycle,” in which foreign capital floods a country, stimulates an economic boom, encourages financial leveraging and risk taking, and eventually culminates in a crash.

They have little patience for the idea that the financial crisis was the fault of Chinese over-saving:

It is necessary to dispense with the view that all this excess saving from the rest of the world was “forced” upon us. The rest of the world’s capital flowed to us, in part, because we wanted to borrow, and we wanted to borrow because of the Bush administration’s emphasis from 2001 to 2008 on cutting taxes while still spending.

They do endorse as exacerbating factors the low interest rates set by the Federal Reserve earlier this decade, and the growth of a large and unregulated financial sector:

Essentially, the development of an unregulated financial sector has circumvented the entire panoply of banking regulation created in the wake of the Great Depression. This made the financial system vulnerable to traditional “bank panics,” or “runs” on the financial system. The abdication of regulatory oversight (particularly in allowing high leverage) in the presence of too many institutions “too large to fail” meant the buildup of implicit financial liability on the part of the government.

But the overall story is that high borrowing brought in foreign capital; insofar as the borrowing was spent on nontradable goods, such as
housing and financial services, necessarily pushing up prices (there is no way for competition from houses in China to keep U.S. housing prices down).

I think it’s hard to argue against the idea that a huge debt-financed bubble was a bad, bad thing. I still think, as you might predict, that the nature of our particular financial system both made the bubble larger than it might otherwise have been, and made its collapse more spectacular than it had to be.

The article is drawn from a book they are working on, which I will be sure to buy.

*By James Kwak*
More On The Two-Track Economy — From The WSJ And Others

Simon Johnson  | 29 Aug 2009

The notion of a two-track economy seems to be taking hold. We kicked the concept around pretty well last week — your 130 comments (as of this morning) helped clarify a great deal of what we know, don’t know, and need to worry about. The two-track concept overlaps with, and builds on, long-standing issues of inequality in the U.S., but it’s also different. Within existing income classes, some people find themselves in relatively good shape and others are completely hammered.

New dimensions of differentiation are also taking hold within occupations and within industries – the WSJ this morning has nice illustrations. The contours of this differentiation begin to shape our recovery or, if you prefer, who recovers and who does not – it’s hard to say how this will play out in conventional aggregate statistics, but these are likely to become increasingly misleading.

For now, I would highlight three points about the two-track future for banks – partly because this matters politically, and partly of the way it impacts the rest of the process.

1. The remaining big banks have become bigger and more powerful economically — the Washington Post emphasized deposits yesterday; good point, but only part of the picture. The Financial Roundtable is tickled pink about the government’s “reform” proposals (except the consumer protection part), with good reason.

2. Many smaller banks are getting squeezed – as reflected in the latest news on the FDIC’s “danger/sick list”. The smaller banks really do not seem to understand how they have been done in by the big banks – if they did get it, they’d be up on Capitol Hill and all over the media arguing strenuously for much tougher controls on bad big bank behavior. The lack of leadership among non-large banks is remarkable.

3. The WSJ today has the data: borrowing costs for large banks are now lower than for small banks. This is, of course, a direct reflection of the government’s firefighting/firesetting strategy: unlimited cheap resources for large big banks; for small banks, not so much.
So now it’s all about whether you are a preferred client of Goldman Sachs or another big finance house.

If you’re on the inside track, this is a great time to buy US assets that are being dumped by people without access to cheap credit, or assets overseas (e.g., Asia, where the “carry” or interest rate differential relative to the Federal Reserve is already positive and the exchange rate risk is all upside).

If you’re on the outside track, you are experiencing a version of Naomi Klein’s “Shock Doctrine”. Some (former) members of the elite are in this category – this is another standard feature of emerging market crises and “recoveries”. But mostly, of course, it’s nonelite on the outside track and a more concentrated, reconfigured version of the elite on the inside.

This can lead to short-term growth – the speed of recovery in many emerging markets surprises many, from about 12 months after the crisis breaks. But it also leads to repeated crisis, to derailed growth, and to a loss of income, status, and prospects for most of society.

By Simon Johnson
The Problems with Regulatory Cost-Benefit Analysis

James Kwak | 31 Aug 2009

Mark Kleiman (hat tip Brad DeLong) says more clearly what I tried to say a while back: cost-benefit analysis of regulations has a curious way of nailing the costs and underestimating the benefits. He focuses on three points:

1. Traditional CBA counts all dollar benefits equally, despite the fact that the marginal utility of a dollar depends a lot on who is getting it; a dollar more for a poor person provides a lot more utility than a dollar more for a rich person.
2. Long-term or uncertain benefits, no matter how large (like preventing the inundation of every coastal city) are typically discounted down to zero.
3. Benefits that are difficult to quantify because there is no market for them (like feeling better because you are healthy) never get counted. (This is the one I know best because it’s one of the things my wife specializes in.)

Matt Yglesias also comments.

By James Kwak
Paulson Was Right (?)

James Kwak  | 31 Aug 2009

The New York Times has a story about how the government is making a profit on its TARP investments: “The profits, collected from eight of the biggest banks that have fully repaid their obligations to the government, come to about $4 billion, or the equivalent of about 15 percent annually.” The article has plenty of appropriate caveats – the total bailout went well beyond TARP, the Citigroup and Bank of America investments and asset guarantees are still out there, we still have a ton of money sunk into AIG – but the fact remains that some of the investments are getting paid back, with interest and with a modest bonus from the warrants issued to Treasury.

There is also an ongoing debate about whether Treasury is getting full value for its warrants, which we’ve covered previously, but let’s leave that aside for now. The bigger question, I think, is this: Did Treasury get a fair deal for its investments at the peak of the crisis?

At the time I said no, and I still think the answer is no. The most important principle to bear in mind is that how a decision turns out has no effect on whether it was a good decision to begin with. In honor of the changing seasons, imagine it’s the first quarter of a football game and you have fourth-and-one at the other team’s 40-yard line. Anyone who studies football statistics will say you should go for it; it’s not even close. (Some people have run the numbers and said that a football team should never – that’s right, never – kick a punt.) If the offense fails to make it, the announcer, and the commentators the next day, will all say that it was a bad decision. That’s completely wrong. It was a good decision; it just didn’t work out.

The same holds true for investing. In this case, Treasury bought some securities from the banks and underpaid significantly, according to both the Congressional Oversight Panel and the Congressional Budget Office. The difference between the amount paid for the securities and their fair value at the time was a subsidy to the banks. What happened here was that Treasury made what was in strictly financial terms a bad investment and then got bailed out by later events. Or, you might say, it bailed itself out by undertaking a series of bank-friendly policies that had the effect of bolstering banks’ share prices and making it easier for them to raise capital. Which raises a whole other question: whether Treasury was counting on their ability to themselves out, and thereby avoid any
eventual criticism for losing money on the deal – but which, at the same time, gave them the incentive to do what was best for bank shareholders.

By James Kwak
Soros and Volcker on Financial Innovation

James Kwak | 31 Aug 2009

I had a business trip late last week, so I used the plane flight home to read *The Sages*, by Charles Morris. It includes three short sketches of Warren Buffett, George Soros, and Paul Volcker, wrapped around the thesis that the recent financial crisis showed the importance of pragmatism and experience rather than sophisticated financial models. Obviously I’m just grabbing a couple of passages here that I found interesting.

Here’s Soros (pp. 42-43):

“...I am a man of the markets, and I abhor bureaucratic restrictions. I try to find my way around them. ... But I do believe that financial markets are inherently unstable; I also recognize that regulations are inherently flawed: Therefore stability ultimately depends on a cat-and-mouse game between markets and regulators. Given the ineptitude of regulators, there is some merit in narrowing the scope and slowing down the rate of financial innovations.”

And here’s Volcker (p. 160), as paraphrased by Morris:

“He scoffed at the notion that clamping down on banks, hedge funds, and other players would stifle ‘innovation.’ The only innovation that real people cared about for the previous twenty or thirty years, he said, was ‘the automatic teller machine.’”

*By James Kwak*
Secrecy and Moral Hazard

James Kwak | 31 Aug 2009

According to Reuters, the Federal Reserve recently got a stay of a federal district court’s order that the Fed must reveal details about which banks accessed its emergency loan programs during the financial crisis. The arguments on each side are pretty straightforward. Bloomberg, the plaintiff, is arguing that the public has a right to know where their taxpayer money,* via the Federal Reserve, is going. The Fed is arguing that if it reveals the names, that could trigger a run on those banks, because customers will worry about their solvency; it is also arguing that revealing names now will make banks less willing to access emergency lending programs in the future, taking away an important tool in a financial crisis.

I find both of the Fed’s arguments weak.

I agree that immediate revelation of who is borrowing at the discount window (the Fed’s facility for lending to banks directly) could make creditors worry about a bank, triggering the modern version of a bank run. (Traditional bank runs shouldn’t happen because of FDIC insurance.) But we’re talking about things that happened last year, and the government has done everything it can to convince the public that the banking system is sound again. Even if Citigroup borrowed at the discount window last September, the ample bailouts it has received since then should convince any jittery investors that Citigroup isn’t going anywhere.

That is also something that apparently Barney Frank and Ron Paul agree on – any Fed disclosure should be delayed by several months.

The second Fed argument is interesting. Basically it says that if banks need to be bailed out in time of crisis, we want the ability to bail them out in secret. This only weakens the incentives for bank managers to run their companies prudently. Knowing that the Fed will bail me out in times of trouble already creates moral hazard. Knowing that they will bail me out without even my shareholders ever knowing only increases the moral hazard. Where does this stop?

* I know you can argue about whether Fed lending counts as “taxpayer money,” since the Fed is arguably an independent entity. The argument on the other side is that when the Fed lends money to dodgy institutions, the ultimate downside risk is taken either by the taxpayer,
or by anyone who has dollar-denominated assets that would be hurt by inflation.

By James Kwak