By Simon Johnson

Should we take seriously people who, in the current US political debate, argue that they are “fiscal conservatives”? No.

These self-labeled conservatives are very far from even being willing to discuss the real issues – let alone make proposals that would have significant effects. As Peter Boone and I argue on Bloomberg this morning, US “fiscal hawks” are just pretending. Perhaps this will prove effective in the midterm elections, but then they will face the music – what exactly will they put on the table that will make any difference at all?

Unless and until you are ready to really reform the financial sector, you cannot be taken seriously in the fiscal space. It’s the big banks that blew up the economy, caused a devastating recession, and pushed up debt by 40 (forty) percentage points relative to GDP.

None of today’s “fiscal conservatives” showed up to work hard on constraining global megabanks over the past 18 months. They have repeatedly and explicitly earned the right not to be taken seriously.


By James Kwak

The Straddler, an online interdisciplinary publication, has an extended interview with me, of all people, so you can see what I talk like.

This is one section I’m proud of:

“Middle class wages have been declining for ten years and stagnant for thirty years, and if you have a financial system that allows people making $15,000 a year to take out $400,000 mortgages, I don’t think that’s the fault of the guy making $15,000. I think it’s the fault of the
financial system.

“But, let’s say I’m a guy who makes $15,000 a year. I realize, wow, I can get a $400,000 mortgage and I can live in this house for a few years, and if housing prices go up, I can flip it and I can actually make a couple hundred thousand dollars. And let’s say I’m really clever, and I say, if housing prices go down, I’ll just walk away and I will have gotten to live in a really nice house for three years at no cost to myself. I mean, that’s the worst, most cynical spin you can put on it, right? But this is exactly what people on Wall Street do. The person who is criticizing the janitor for doing this is the same person who thinks that businesses should exploit every legal opportunity to make profits. So even if you attribute the worst possible state of mind to the guy making $15,000, he’s still just doing what any businessman should do under the circumstances. But our national ideology somehow doesn’t allow us to think about it in those terms.”

Enjoy.

The White House Needs Elizabeth Warren, Now More Than Ever

The White House today is under pressure, with insiders asking: After the strong showing of the Republicans in the midterm elections, should the president move to the right or to the left?

This is entirely the wrong way to think about the problem – the administration needs to get beyond its mental framework of early 2009, which led it sadly astray with regard to the financial sector. The President needs to find people and themes capable of cutting across the political spectrum; specifically he needs to promote strongly the ideas of Elizabeth Warren – what we need in financial services, above all else, is much more transparency.

The premise – and central mistake – of the Obama administration in 2009-10 can be summed up in what the president said to leading bankers on that fateful day, March 27, 2009: “My administration is the only thing between you and the pitchforks”.

The organizing notion then, provided by Larry Summers and presumably Tim Geithner, was that the “responsible” administration would protect global megabanks from “dangerous” populists, in return for cooperation and better behavior. This kid gloves strategy turned out to be a very bad bet – not only is it far from best practice with regard to handling failed financial systems (there must be consequences for executives and shareholders, at the very least), but it also allowed banks and
their close allies to bounce back to profitability and use that cash (underwritten by the taxpayer) to oppose the administration on financial reform and, according to credible public reports, to funnel large amounts of money into various “populist” anti-administration midterm campaigns.

A lot of pitchforks ended up being paid for by the 13 Bankers, in various forms (e.g., Chamber of Commerce; American Financial Services Association).

The administration, to its credit, did see Elizabeth Warren as an important potential ally early on – hence the emphasis on the new consumer protection agency for financial products. But the White House also should have played this card more aggressively by stressing at every turn Professor Warren’s central idea, the need to protect families from opaque small print and deceptive practices.

The Chamber of Commerce and other lobbyists help spend bank profits framing the consumer protection debate as being about “regulation,” but that is not the issue. We have had plenty of regulation in recent decades and still have lots of regulators. The issue is capture. Big banks in particular disproportionately captured the hearts and minds (and maybe more) of federal regulators.

The best idea for rolling this back is Elizabeth Warren’s – require more transparency and full disclosure. In effect, this is applying the best idea from the 1930s reforms (when it was applied to securities and other investments) to mortgages and credit cards. In the 1920s, there were terrible abuses of consumers around the investments that they were sold (see Michael Perrino’s new book). In the 2000s, the abuses were concentrated on the liabilities side of the consumers’ balance sheet, i.e., on what they borrowed; again these were egregious abuses.

This is the key point that Ms. Warren communicates effectively time and again – and to very broad audiences (including CEOs, in her effective no-drama style). The nonfinancial private sector completely gets and understands this point; if you sold boxed cereal in the same way that financial services have been sold (by some people), you would be kicked out of the boxed cereal business – by your industry colleagues. The financial sector, unfortunately, has lost its moral compass and ability to police itself. The right approach is to require full disclosure of all material information – just as we do for the securities industry. It’s not perfect, to be sure, but it has served us well for going on 80 years.

President Obama is worried about his left and needs to think also where the center is heading. He needs an issue that cuts across left and right. The left hates the abuse of power at the center of the financial system, but the right also understands that “too big to fail” is not a market – it’s an implicit government subsidy scheme, it’s a dangerous, unfair, and nontransparent form of taxpayer abuse, and it should stop.

If the administration goes onto the defensive on these issues in response to the election, the Chamber of Commerce and its fellow travelers will have a field day. Fresh from its successes in the midterms and backed by an increasing wave of clandestine and – by the way, foreign – money, the Chamber will attack again and again.
What the president needs is someone who can take the fight to the Chamber – force them publicly to defend business practices that are unacceptable and abhorrent to responsible entrepreneurs and executives. (If you doubt whether Elizabeth Warren can pull this off, see her recent speech to the Financial Services Roundtable.)

The problem is absolutely not “fat cat bankers” (if you know a term that more effectively unifies potential supporters of the Chamber of Commerce, let me know). It is that a few people (and their prominent organizations) at the center of our financial system got out of control. We can fix this problem – there is no reason to subject ourselves to the risks inherent in these individuals having excessive power and an inclination to take advantage of ordinary people.

The nonfinancial sector gets this. Community bankers get this. Hedge funds get this. Even people who work in bigger banks (but not the biggest or worst behaved) get this. And people who, until recently, worked in the global megabanks also get this.

But we need a champion. Deputy Treasury Secretary Neal Wolin railed against the Chamber of Commerce earlier this year for its lobbying activities against reform, but he is too low profile to get much traction. Secretary Geithner may now understand these issues but he is not the greatest communicator to the broader public. And the rest of the Obama economic team looks, at best, rudderless – what exactly do they stand for or against?

Elizabeth Warren has the vision, the credibility, and the communication skills needed to really bring overdue changes to our financial system – and to lay the groundwork for 2012. If the White House downplays her role or themes, the next two years will be very difficult.

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**Will the Volcker Rule Survive The Midterm Elections?**

The Baseline Scenario » 2010 » November 11/4/10 at 5:46 AM Simon Johnson

*By Simon Johnson*

The Obama administration saved the deeply troubled megabanks in the United States in early 2009 with a bundle of rescue measures that, compared with similar financial crises elsewhere, stands out as extraordinarily generous – particularly to the bankers at the epicenter of the disaster.

The banks responded to this magnanimity with – by all accounts – extraordinarily generous support for the Republicans leading up to this week’s midterm elections. Why would they do this?

The answer is straightforward: The Republicans have promised generally not to tighten restrictions
on the financial sector, which means specifically that they will seek to make the recent Dodd-Frank financial regulatory legislation less effective.

The Dodd-Frank Act is not strong legislation to start with. The administration started with overly modest goals, and the banks then devoted considerable effort to weakening the bill as it passed through the House. But some pieces that survived have the potential to make a difference – including the Volcker Rule, which in principle would force big banks to get out of the business of betting their capital in ways that can bring down the entire financial system.

Paul Volcker came up with the ideas and helped shape the original proposed rule. This provision was pushed hard by Senators Jeff Merkley of Oregon and Carl Levin of Michigan, who prevailed against the odds in getting it into the bill, but now find regulators less than uniformly enthusiastic about applying the rule.

This brings us to the details – where all relevant devils reside. That your eyes may glaze over, is, as far as the banks are concerned, a desirable feature, not a bug. Comments to the Financial Services Oversight Council on implementing the rule are due tomorrow; a few are already in, and more may be submitted at the last minute, in the hope of deterring rebuttal. (The banks can also rely on more private channels to make their views known.)

You can view the request for comment or search for the public submissions; when the site opens, click on the box for “public submissions” and a list of them will appear.

One comment, from State Street (on behalf of itself, Northern Trust and BNY Mellon), is instructive with regard to both substantive issues being debated before regulators and the broader political debate going forward.

The State Street argument is that the relevant section (§619) of Dodd-Frank could prevent a bank “from providing traditional directed trustee or similar services to its pension fund and other institutional clients.”

The issue, State Street points out, is “potential banks’ support for the investment performance of the fund” – that is, whether a bank would feel obliged to prop up the performance of a fund that is struggling. The problem with such propping up is that it will help a fund show better performance on average – and therefore help it attract more money – but it would also mean a bigger collapse, with much more devastating consequences, should subsequent problems arise (which is not so uncommon). Propping up is a fairly common phenomenon around the world.

State Street and its co-signers argue that banks such as themselves frequently do not have investment authority over plans for which they are trustees. But this is not the issue.

The real question is whether a custodial bank of any kind would have the incentive to prop up performance of a fund (of any kind). This is the way that banks can find themselves committing
capital, whether they originally intended to or not. The sounder relationship between bank and fund is that when bad things happen, the bank is content to let the fund fail (or just show disappointing performance).

State Street and the other big banks mostly just want to be left alone. “We’re big boys and we can take care of ourselves” is their refrain – and you will now hear this echo far and wide, at least in the House of Representatives as we head into 2011.

This was exactly the operating philosophy of Alan Greenspan, circa 1997: “As we move into a new century, the market-stabilizing private regulatory forces should gradually displace many cumbersome, increasingly ineffective government structures” (quoted in “13 Bankers“).

The new century has not, so far, gone well, precisely because “market-stabilizing private regulatory forces” turns out to be an oxymoron.

And the specifics at stake here are far from hypothetical. Remember that Citigroup had large “off-balance sheet” housing-related liabilities that it ended up bringing back onto the balance sheet – thus absorbing the losses and forcing itself closer to insolvency. And even State Street had to prop up some of their “stable value funds”.

The designers of the details of the Volcker Rule – and their political masters – should not repeat Mr. Greenspan’s tragic and costly mistake. We need a real firewall between custodian banks and the funds with which they are connected in any form. The Volcker Rule, if properly and rigorously applied, can do just that.

An edited version of this post appears this morning on the NYT.com’s Economix blog; it is used here with permission. If you wish to reproduce the entire post, please contact the New York Times.

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By Simon Johnson

Writing in the Financial Times today, Paul Ryan – the incoming chair of the House Budget Committee – presents himself as a fiscal conservative, primarily focused on bringing the budget deficit and government debt under control. He is not.
Only in American could self-styled “fiscal conservatives” say that “America is eager for an adult conversation on the threat of debt,” but then decline to discuss the first order problem that has brought us here and threatens us going forward: Dangerous systemic risk brought on by the reckless behavior of big banks. No “fiscal conservatives” showed up for the legislative fight to rein in big banks – none, and now Spencer Bachus (presumptive incoming chair of House Financial Services) says that restrictions on big banks should be further lifted (quoted in the FT today, p.15).

We can reasonably draw only one conclusion: Paul Ryan and his colleagues are not real fiscal conservatives. This is further confirmed by the following:

1. Paul Ryan’s main short-term suggestion in his FT piece today is: Cut taxes. Anywhere else in the world you would be laughed out of the room for suggesting this as the first step towards bringing a government’s fiscal house to order.

2. For concrete proposals on spending cuts, Mr. Ryan refers us to the Republican “Pledge to America”. But that Pledge has no such detail on anything that would make a first-order difference, i.e., add all their proposals together and it wouldn’t even make a noticeable dent in the government debt path. If a politician can’t summarize his main suggestions in an op ed, there are no real suggestions.

3. Mr. Ryan is right to bring up the need to make small adjustments to Social Security; this has been done before and makes sense. But the major budget buster in the CBO baseline, as you get out to 2030, is Medicare. What exactly is Mr. Ryan proposing in terms of controlling those costs? On current demographic and technology projections – with the existing cost structure – even if you cut benefits substantially, Medicare becomes unaffordable. Who will be squeezed over time – beneficiaries, providers, or payers – and how exactly? This will be a tough and emotional conversation – the lobbies here are almost as powerful as banks – but Mr. Ryan is not even starting us in the right direction.

Mr. Ryan has an important job in the next Congress and will no doubt have great influence on Republican policy in the run up to the 2012 presidential election.

The White House would do well to take him and his colleagues on directly. We should have the debate about our long-term fiscal future and lay out a path to sustainability that is consistent with an economic recovery.

It is up to the Obama administration to explain clearly and widely why Mr. Ryan’s proposals do not deal with the first order problems that have increased government debt dramatically in the past decade and that threaten future fiscal stability. Let us hope the White House has learned from the midterms that there are dire electoral consequences when the president shrinks from directly confronting misleading ideas.
By James Kwak

For those of you lucky enough to live in Western Massachusetts, the Political Economy Research Institute is hosting a panel tomorrow (Friday) from noon to 1:30 with not one, not two, but three prominent econobloggers: Doug Henwood of Left Business Observer, Mike Konczal of Rortybomb, and Yves Smith of naked capitalism. And your humble blogger will be moderating. It’s at the University of Massachusetts, on the third floor of Gordon Hall.

Is This What You Voted For?

By James Kwak

In What’s the Matter with Kansas? Thomas Frank described how the Republican Party was able to take advantage of the conservative, values-focused, evangelical-driven movement to come to power—and then paid lip service to the priorities of the “base,” instead pursuing policies that helped established business interests and the rich. On a national scale, this was one major reason why conservatives became so disillusioned with George W. Bush.

It’s no surprise to anyone that this is happening again, only substituting “Tea Party” for “evangelical conservatives” and “United States” for “Kansas.”

Spencer Bachus, the likely new chair of the House Financial Services Committee, has announced that he is planning to use whatever powers he can to gut the Dodd-Frank financial reform bill. Why? According to the Financial Times, Bachus “expressed concern that shareholders of Goldman Sachs and JPMorgan Chase will be hurt because the banks will be less profitable.”

So one major effect of the Tea Party movement will be to further enrich Wall Street banks and the bankers who work there. (Which, I guess, is consistent with the common Tea Party insistence on reducing taxes for the rich.)

Is this what you voted for?

(If not, Mike Konczal reminds us that tomorrow is the deadline to submit comments on the
By James Kwak

Investors are claiming that Bank of America’s servicing operations are milking delinquent mortgages to earn fees rather than either foreclosing or modifying the mortgages. Bank of America’s defense?

“We have no financial incentive to keep mortgages on the books longer. Isn’t it better to modify the loan and keep people in their homes rather than foreclosing?”

I’m glad you feel that way. Then why do you have the second-lowest permanent modification rate of the seventeen servicers and two other servicer categories whose data have been released by Treasury?

By Simon Johnson. This is the text of a letter (about 2,000 words) submitted on Friday to the Financial Stability Oversight Council, in response to their request for comments on the Volcker Rule. The full letter is here and on regulations.gov. If you would like more background on the Volcker Rule and its political importance, please see this post and the links it provides.

Dear Members of the Financial Stability Oversight Council:

Thank you for the opportunity to submit these comments on the study regarding implementation of Section 619 of the Dodd-Frank Act, also known as the Merkley-Levin provisions on proprietary trading and conflicts of interest or as the Volcker Rule.

Summary

I would like to offer three main comments.
1. Mismanagement of risks that involved effectively betting the banks' own capital was central to the financial crisis of 2008; this is why our largest banks failed or almost failed. The Merkley-Levin Volcker Rule, properly defined, would significantly reduce systemic financial risks looking forward. Congressman Bachus's comment to contrary (as submitted to the FSOC, as part of the Public Input for this Study, dated November 3, 2010) is completely at odds with the facts.

2. Trades need to be scrutinized in a detailed and high frequency fashion. It is not enough to rely on relatively infrequent and "high level" inspections – or the established supervisory process. The comments provided to you in this regard by Senator Harkin (dated October 20, 2010) – and also by Senators Merkley and Levin (dated November 4, 2010) – are exactly on target.

3. The separation between banks and the funds they sponsor, in any fashion, needs to be complete. The argument offered by State Street and other "Custodian Banks" in their comment to you (dated October 27, 2010) is worrying and potentially dangerous, because it ignores the basic economics that leads to bank failure.

The remainder of this letter expands on these points.

**The Importance of the Volcker Rule**

With regard to the importance of the Volcker Rule (e.g., for your Question #12), James Kwak and I provided a great deal of supportive evidence in our book, *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown* (see [http://13Bankers.com](http://13Bankers.com)). American prosperity does not rest on having global megabanks of this nature and scale; we definitely do not need them to have proprietary trading businesses. They pose great dangers to our financial system – and to taxpayers, as seen in the aftermath of the 2008 financial crisis. Please be sure to take our analysis into account when considering this matter.

The Volcker Rule is not a panacea but if designed and implemented appropriately, it would constitute a major step in the right direction. The effectiveness of our financial regulatory system declined steadily over the past 30 years; it is time to start the long process of rebuilding it.[1]

With regard to your Question #6, on capital requirements, which is closely related to these general questions, I urge you to read the latest writings from leading analysts of this issue.[2]

In particular, I would stress that Professor Anat Admati and her colleagues find that stronger capital requirements would not be contractionary for the economy (see footnote 2). Professor Jeremy Stein and his colleagues show that capital requirements can and should be increased through requiring specific dollar amounts of capital to be raised – rather than through requiring banks to hit a particular capital-asset ratio (see footnote 2). If you proceed in the fashion that they recommend, stronger capital requirements will make the financial system safer – without any discernible effect on short-run growth and making it more likely that we can sustain reasonable growth rates over the next 10 years.

Related, and with regard to your question #10, Congressman Bachus argues at length that our
international trading partners will not adopt any measures parallel to the Volcker Rule and therefore we should shy away from implementing the Rule. This is a non sequitor.

Our biggest banks have become dangerous by any reasonable standard – the supporting evidence is the deepest recession since 1945, more than 8 million jobs lost, and a 40 percentage point increase in the ratio of privately held federal government debt-to-GDP. If other countries fail to follow our lead, that is worrying – mostly because they will be setting themselves up for further trouble.

Please look at my assessment of financial sector policy and fiscal impact in Europe (joint with Peter Boone). Europe faces serious difficulties because of failures to control the behavior of major banks. We should in no way be inspired to follow their lead. The US needs to deal with its own problems first – and then encourage other countries to do likewise.

If dangerous and irresponsible activities – financial or otherwise – leave the United States for elsewhere, we should in no way encourage them to stay here. Instead we should focus on warning others about why they (and the global economy) will not benefit from harboring and tolerating such behavior.

Congressman Bachus argues that implementing the Volcker Rule will hurt the shareholders of major banks. This is far from clear – shareholders lost heavily when banks’ gambles went so dramatically wrong in 2007-08. But even if it were the case, this would be irrelevant. The goal of your rule making is surely not to help a particular set of shareholders, but rather to strengthen financial stability and increase the likelihood that we will not fact another devastating financial crisis.

You should definitely and deliberately avoid actions that elevate the interests of bank shareholders above broader social concerns. The goal here is precisely to step back from the “too big to fail” implicit subsidy arrangements that have developed around our biggest banks in recent years.

**Degree of Required Scrutiny**

Relevant to your Question #2, I strongly support the views of Senator Harkin, as expressed in his comment to you on October 20, 2010, as well as the positions of Senators Merkley and Levin, in their comment to you on November 3, 2010. I testified in favor of the Volcker Rule in February to the Senate Banking Committee and respectfully suggest that you take my testimony into account when considering this matter.

On the same panel in February, representatives of Goldman Sachs Group Inc. and JPMorgan Chase & Co. pushed back strongly against the Volcker Rule. Given the adamancy with which those banks argued so recently against the Volcker Rule, it is not unreasonable to wonder about their intentions now.
If a bank’s management wants to take proprietary risks using its own capital, these would be relatively easy to disguise on a trading desk as “customer flow” in some way. Some big banks have already announced that proprietary trading jobs will be cut, including at JPMorgan after the firm reportedly lost $250 million on coal trades in the second quarter (although perhaps these developments are not connected). Bank of America Corp. has announced that proprietary traders will be switched to other jobs within the firm.[7]

But as Michael Lewis asked recently: how would anyone know whether proprietary trading reappears in disguise? Lewis also pointed out that, at least in the case of Goldman Sachs, some of the most important transactions with regard to committing or protecting the firm’s own capital in the recent past were undertaken by their so-called Client Facing Group (see footnote 6). This doesn’t imply there was any deception, simply that risks can be placed in any number of locations within such an organization.

We know that big banks like to bet big, particularly as the credit cycle develops. Sometimes this goes well for them and their shareholders, and other times it goes badly as it did for Goldman Sachs when it reported losses on equity derivatives in the second quarter. When large bets go bad the damage can be so catastrophic that the entire credit system is disrupted and the tax payer is again on the hook. Again, please consider my work with Peter Boone for your deliberation on this matter (cited in footnote 3 above.)

There is no way to handle the failure of global megabanks because there is no cross-border resolution mechanism or bankruptcy procedure that can handle their failure, a point I made with co-author James Kwak in 13 Bankers. The idea that too big to fail has been legislated away is simply an illusion.

There is nothing anti-business about wanting to enforce the Volcker Rule. Quite to the contrary, the severity of the financial collapse in the fall of 2008 was very much about how big banks acquired and mismanaged huge risks — not all of which were within officially designated prop-trading groups — and in the process damaged the rest of the financial industry and the broader economy.

The Volcker Rule may not be perfect but at this stage it’s almost all we’ve got. And with regard to voluntary compliance by the big banks, we should reflect on Ronald Reagan’s thinking with regard to nuclear disarmament commitments by the Soviet Union, “trust, but verify.”

**Relationship Between Banks And Investment Funds**

Relevant to your Questions #3 and #4, you received on October 27, 2010, a comment from State Street (on behalf of itself, Northern Trust and BNY Mellon), which I would strongly oppose.[8]

The State Street argument is that section 619 of Dodd-Frank could prevent a bank “from providing traditional directed trustee or similar services to its pension fund and other institutional clients.”
The issue, State Street points out, is “potential banks’ support for the investment performance of the fund” – that is, whether a bank would feel obliged to prop up the performance of a fund that is struggling. The problem with such propping up is that it will help a fund show better performance on average – and therefore help it attract more money – but it would also mean a bigger collapse, with much more devastating consequences, should subsequent problems arise (which is not so uncommon). Propping up is a fairly common phenomenon around the world.[9]

State Street and its co-signers argue that banks such as themselves frequently do not have investment authority over plans for which they are trustees. But this is not the issue.

The real question is whether a custodial bank of any kind would have the incentive to prop up performance of a fund (of any kind). This is the way that banks can find themselves committing capital, whether they originally intended to or not. The sounder relationship between bank and fund is that when bad things happen, the bank is content to let the fund fail (or just show disappointing performance).

State Street and the other big banks mostly just want to be left alone. “We’re responsible adults and we can take care of ourselves” is their refrain. This was exactly the operating philosophy of Alan Greenspan, circa 1997: “As we move into a new century, the market-stabilizing private regulatory forces should gradually displace many cumbersome, increasingly ineffective government structures” (as quoted in 13 Bankers, p.101).

The new century has not, so far, gone well, precisely because “market-stabilizing private regulatory forces” turns out to be an oxymoron.

And the specifics at stake here are far from hypothetical. Remember that Citigroup had large “off-balance sheet” housing-related liabilities that it ended up bringing back onto the balance sheet – thus absorbing the losses and forcing itself closer to insolvency.[10] And even State Street had to prop up some of their “stable value funds”. [11]

Please do not repeat Mr. Greenspan’s tragic and costly mistake. We need a real firewall between custodian banks and the funds with which they are connected in any form. The Volcker Rule, if properly and rigorously applied, can do just that.

Yours sincerely,

Simon Johnson

Footnotes

[1] Not surprisingly, there is a great deal of agreement among leading academics, financiers, and
other business people on the need to rein in – as much as possible – reckless risk-taking by very large banks. As an example, see the endorsements provided by a broad cross-section of prominent figures for the arguments in 13 Bankers: [http://13bankers.com/reactions/#endorsements](http://13bankers.com/reactions/#endorsements).


[5] The fact that our biggest banks want to become even larger and even more global should worry us a great deal – particularly as there is no cross-border resolution mechanism for banks on the horizon. Please see the details and analysis in “Way Too Big To Fail,” [http://www.tnr.com/article/economy/magazine/78563/way-too-big-fail](http://www.tnr.com/article/economy/magazine/78563/way-too-big-fail).


By Simon Johnson. As prepared for the NYT's Room for Debate – for the context and the whole discussion, see this link.

In a world with so many instabilities, there is an understandable search for something that offers a stable value – preferably something that cannot be affected by the whim of government or the latest scheme of a central bank. Unfortunately, this search proves just as illusory as the pursuits of alchemists in pre-modern times; there is no magic to gold.

For international economic transactions, proposing any kind of return to the gold standard is equivalent to wanting more fixed exchange rates, i.e., moving away from market-determined rates and returning to the system, at least in part, to how it operated before 1971.

But it is hard to imagine how this would help with regard to the major currencies, which are again the subject of controversy today. The main issues in the US are high unemployment, an unstable financial system, and longer-term issues around the budget. How exactly would gold help on any dimension? Advocates of a modified gold standard argue that this would serve as a form of anchor to the system – but in the 1930s it proved to be an anchor tied around the neck of some countries, including the United States. Nobody needs the kind of “stability” associated with the Great Depression.

And China’s exchange rate today is controversial precisely because it is essentially fixed in nominal terms against the dollar. Adding gold as a reference point for China’s exchange rate would do nothing to affect the problem – China keeps its currency undervalued in real terms, aiming for a large current account surplus. This is unfair and violates both the rules of the exchange rate system and the reasonable expectations of its trading partners.

The world – and the G20 – needs to confront its main problems: global banks have become far too powerful, financial reform has failed, and we are setting ourselves for another dangerous credit cycle – which will again devastate jobs. The G20, incredibly, has refused to take up the issue of how to handle the failure of megabanks when these operate across borders. The failure of leadership and responsibility at the Seoul summit is profound.
Proposing a modified gold standard is at best a distraction. At worst, it may be latched onto by people who wish to further divert us from the real problems.

By Simon Johnson

The Group of 20 summit for heads of government this weekend will apparently “hail bank reform,” particularly as manifest in the Basel III process that has resulted in higher capital requirements for banks. According to leading authorities on the issue, however, the Basel process is closer to a disaster than a success.

Bank capital can be best thought of as the amount of financing of a bank’s operations (lending and investment) that is covered by equity and not by debt obligations. In other words, it describes how much of the assets of the bank are subject not to the “hard claim” of debt but rather to a residual or equity claim, which would not lead to distress or insolvency when the value of the asset goes down. For global megabanks, equity capital is thus a key element in preventing the failure of an individual institution (or a couple of banks) from bringing down the financial system.

The framing of the Basel “success,” according to officials, is that the big banks wanted to keep capital standards down — and this is definitely true — but that governments pushed for requirements that are as high as makes sense. The officials implicitly conceded the banks’ main intellectual point, that higher capital requirements would be contractionary for the economy.

But according to top academic experts on this issue — people who know more about banks and bank capital than anyone else on the planet — the banks have misrepresented and the officials have misunderstood reality.

In a letter published in The Financial Times this week, Professor Anat Admati (Stanford University) and her colleagues — a Who’s Who of finance — make three main points.

First, the basic economics behind official thinking is wrong.

“Some claim that requiring more equity lowers the banks’ return on equity and increases their overall funding costs,” thus lowering economic growth, the professors write. “This claim reflects a basic fallacy. Using more equity changes how risk and reward are divided between equity holders and debt holders, but does not by itself affect funding costs.”
They go on to say: “High leverage encourages risk taking and any guarantees exacerbate this problem. If banks use significantly more equity funding, there will be less risk-taking at the expense of creditors or governments.”

Second, the Basel process uses dysfunctional methods to adjust capital requirements to reflect the risk of various kinds of assets.

“The Basel accords determine required equity levels through a system of risk weights,” they write. “This system encourages ‘innovations’ to economize on equity, which undermine capital regulation and often add to systemic risk. The proliferation of synthetic AAA securities [around U.S. housing loans] before the crisis is an example.”

Third, capital requirements should be simplified and greatly increased — relative to what the Group of 20 leaders will congratulate themselves on.

“Lending decisions would be improved by higher and more appropriate equity requirements,” they say.

And they are also completely on target with regard to the political economy problem here: “Many bankers oppose increased equity requirements, possibly because of a vested interest in the current systems of subsidies and compensation. But the policy goal must be a healthier banking system, rather than high returns for banks’ shareholders and managers, with taxpayers picking up losses and economies suffering the fallout.”

This is not extraordinary language per se — you can see the same sentiments, for example, echoed throughout the new movie “Inside Job” (which I highly recommend, as does the reviewer for The New York Times; disclosure, one sound bite from me appears in the movie). And I have advanced similar views on this blog over the past 18 months (e.g., see this post).

But to have the intellectual leaders of the finance profession weigh in so heavily and with such language is huge. Officials claim that they are the custodians of best practice in economics. If you criticize them on this or any other issue, they will roll their eyes — implying you do not understand reality or the insights of the truly deep thinkers.

So here are the deepest thinkers — founders and mainstays of the entire field of finance — finally standing up and saying: Enough of this nonsense. You may wish to pretend that keeping capital requirements low is a good idea, but you should understand that this is pretense and bad science, pure and simple.

Remember that most productive firms in our economy are financed with equity — shareholding is at the heart of the American economic model. Bankers make it sound as if something is wrong with being equity-financed, but all these big banks are publicly traded in any case. They just need to raise more equity and rely less on debt. This would not be difficult — and definitely not disruptive to
the nonfinancial “real” part of the economy.

There is no intellectual case for the Basel process on its current basis or for the outcome that will be discussed this weekend. The Group of 20 leaders are kidding no one but themselves when they endorse this approach.

The Group of 20 has completely failed to do what is necessary to rein in global megabanks — and to make them safer.

Listen to the leading minds of the finance profession and take corrective action now, before it is too late.

An edited version of this post appeared today on the NYT.com’s Economix; it is used here with permission. If you wish to reproduce the entire post, please contact the New York Times.

Vikram Pandit Has No Clothes

Vikram Pandit heads Citigroup, one of the world’s largest and most powerful banks. Writing in the Financial Times Thursday morning, with regard to the higher capital standards proposed by the Basel III process, he claims

“There is a point beyond which more is not necessarily better. Hiking capital and liquidity requirements further could have significant negative impact on the banking system, on consumers and on the economy.”

Mr. Pandit is completely wrong. To understand this, look at the letter published in the Financial Times earlier this week by finance experts from top universities – the kind of people who trained Mr. Pandit and his generation of bank executives.

The professors write,

“Basel III is far from sufficient to protect the system from recurring crises. If a much larger fraction, at least 15%, of banks’ total, non-risk-weighted, assets were funded by equity, the social benefits would be substantial. And the social costs would be minimal, if any.”

The point is that “bank capital” just reflects the choice between debt and equity – to “have more
"High leverage encourages excessive risk taking and any guarantees exacerbate this problem. If banks use significantly more equity funding, there will be less risk taking at the expense of creditors or governments."

"Bankers warn that increased equity requirements would restrict lending and impede growth. These warnings are misplaced. First, it is easier for better-capitalized banks, with fewer prior debt commitments hanging over them, to raise funds for new loans. Second, removing biases created by the current risk-weighting system that favor marketable securities would increase banks' incentives to fund traditional loans. Third, the recent subprime-mortgage experience shows that some lending can be bad for welfare and growth. Lending decisions would be improved by higher and more appropriate equity requirements."

Mr. Pandit is a smart individual and he knows all this – he has a Ph.D. in finance from Columbia University. Why then does he advance such obviously specious arguments in the pages of the Financial Times?

The answer is straightforward.

a) He can get away with it. Modern financial CEOs float in a cloud above the public discourse; they can spout nonsense without fear of being contradicted directly in the pages of a leading newspaper.

b) Officials listen to bank CEOs and an op ed gets their attention. Perhaps they think Mr. Pandit knows what he is talking about – or perhaps they know that these arguments are completely specious. In any case, they are deferential.

c) Mr. Pandit is communicating with other CEOs and, in this fashion, encouraging them to take recalcitrant positions. There is an important element of collusion in their attempts to capture the minds of regulators, politicians, and readers of the financial press.

Mr. Pandit is engaged in lobbying, pure and simple. Ask the people who invented modern finance theory and figured out how it should be applied (second to last paragraph),

"Many bankers oppose increased equity requirements, possibly because of a vested interest in the current systems of subsidies and compensation. But the policy goal must be a healthier banking system, rather than high returns for banks' shareholders and managers, with taxpayers picking up losses and economies suffering the fallout."
By Simon Johnson

Early Friday I went through the G20 communique for the Wall Street Journal; a marked up copy is available on-line.

It is hard to imagine how the summit could have gone any worse for the US Treasury and the president. The spin machine is now working overtime – and you’ll see big efforts to get more positive stories over the coming week – but on all fronts the outcome is very bad.

1. There was no substantive progress on anything to do with exchange rates. The “indicative guidelines” to be agreed next year are just a way to kick the can down the road. The Chinese are digging in hard on their exchange rate; this is headed towards a mutually destructive trade war.

2. There was less disagreement at the summit regarding the ”regulation” of global megabanks – but only because this had been gutted so effectively by the bankers’ lobby and officials who bought their specious arguments. There is nothing here that will prevent or limit the impact of another major worldwide financial crisis.

3. On IMF governance, over which there was substantial fanfare in advance, it turns out there has been a major step backwards. The Europeans have apparently signaled they are no longer willing to give up the job of Managing Director – they have always controlled this job and this is a major reason why IMF legitimacy remains weak. Unless and until an emerging market person gets this position, no one (outside of Europe) will want to rely on the IMF in an emergency. As a result all countries will want to “manage” their exchange rates – to the extent they can – along Chinese lines, aiming for a significant current account surplus (so as to build up foreign exchange reserves). See point #1 above for the likely consequences of that.

Dear Mr. President

By James Kwak

There have been (admittedly unclear) indications from your administration that you may accede to the Republicans’ demand to extend the Bush tax cuts for everyone. I urge you not to do this.

The question is: Is it better to extend the tax cuts for everyone or for no one? The answer is to
extend them for no one.

The Bush tax cuts have always overwhelmingly benefited the rich, not the middle class, and that is no less true today than when they were enacted. They were bad policy then and they are bad policy today. Extending the tax cuts would dramatically enrich the wealthy relative to everyone else. 65.5 percent of the total benefit would go to the top quintile by income, 26.8 percent to the top 1 percent, and 14.7 percent to the top 0.1 percent.*

Leaving aside discredited, Reagan-era theories about trickle-down economics, there are two main arguments for extending the tax cuts:

1. **You shouldn’t “increase”** taxes during in tough economic times.

It is true that tax increases would have a modest first-order negative impact on economic growth. But that impact will be small (per dollar of net fiscal impact) for exactly the same reasons that tax cuts are a poor stimulus. The multiplier for tax cuts is far lower than the multipliers for virtually every other type of government spending, especially aid to state and local governments. In particular, the economic impact of tax increases is smaller when they go to the rich rather than the middle class, because the rich consume a smaller portion of their marginal income. In addition, letting the tax cuts expire would have positive second-order effects because it would improve the government’s fiscal balance, which is widely (though perhaps incorrectly) perceived as a source of risk to the economy.

Now, it might be preferable to extend the tax cuts only until the economy recovers and then let them expire. But that is probably politically infeasible, and in any case creates the risk that, at that point, Congress would then make the tax cuts permanent.

2. **The tax cuts will help the middle class.**

Yes, but they won’t help very much. If the tax cuts are extended, the average benefit for tax units (roughly speaking, households) in the middle income quintile will be $880 per year.*** By contrast, tax units from the 80th to 99.9th percentile will gain $6,094 each, and the top 0.1 percent–those with over $2 million in annual income–will gain $339,473 each.

Now, $880 means a lot to a middle-class family, and I will no doubt be called heartless for saying we should extend the tax cuts for no one rather than everyone. But letting the tax cuts expire will be better for the middle class, for one big reason–actually, 3.7 trillion reasons.

$3.7 trillion is the figure that is generally cited as the projected ten-year impact of the Bush tax cuts. Letting the tax cuts expire will eliminate $3.7 trillion from the projected national debt with one stroke. Why does this help the middle class? Because Social Security and Medicare are currently under assault. The national debt is being used as a bogeyman to frighten politicians (and the people who elect them) into agreeing to significant reductions to Social Security and Medicare.
Yet middle-class households need Social Security and Medicare far more than they need $880 of current-year income. Our country faces the very real threat of a retirement security crisis, since saving via 401(k) plans is shockingly low; in 2007, the average retirement account balance for a household where the head of household was between ages 55 and 64 was only $63,000 (Federal Reserve Survey of Consumer Finances, Table 6). That figure is surely lower today, after the financial crisis. And your administration knows very well the problem of health care cost inflation, having done more to attempt to solve this problem than any other administration, ever.

The single most important thing you could do to protect the retirement and health care security of the vast majority of Americans would be to let the tax cuts expire. The CBO (full document, Table 1-7) projects the cost of those tax cuts in 2020 at $368 billion, or 1.6 percent of GDP. The tax cuts mean the difference between a federal deficit of 3.0 percent of GDP (probably sustainable) or 4.6 percent of GDP (probably unsustainable). Removing that enormous wedge from the structural deficit would reduce the current pressure for “entitlement reform” and give the cost-saving provisions in your health care reform bill time to work.

In short, letting the tax cuts expire would be better for the middle class (and even more so for the poor–the lowest quintile would gain only $45 from extension), and for the country, than extending them for everyone.

Since you have a reputation for putting the welfare of the country before your political fortunes and those of your party, I hope this should be enough to convince you. But I believe this would also benefit you politically. If the American people want to know why their taxes will be higher in 2011 than 2010, this is what you can say:

“We face a grave threat to our nation’s future prosperity. That threat is a ticking time bomb set by my predecessor’s administration. In 2001 and 2003, my predecessor pushed through enormous tax cuts for the very wealthy, using small tax cuts for the middle class as a fig leaf. Instead of being honest about the impact this would have on our national finances, his administration timed the tax cuts to expire on December 31, so they could pretend they were smaller than they actually were.

“The Republicans want to let this time bomb explode. They want to make these tax cuts for the wealthy permanent, meaning that families making more than $2 million would save $300,000 in taxes, while ordinary families would save less than $1,000. This is at a time when our governments–federal, state, and local–lack the resources necessary to provide basic services to our citizens, secure our borders, educate our children, provide health care to the elderly, and invest in our economy.

“My proposal is to extend the tax cuts for the middle class, but not for the wealthy. The Republicans, who control the House of Representatives [see Update below], insist on
permanent tax cuts for the rich—tax cuts that load debt onto our children and grandchildren for decades to come. They are willing to sacrifice our future prosperity so that millionaires can save hundreds of thousands of dollars.

“I refuse to force future generations to pay for our own failure to make hard choices. I refuse to allow an enormous hole in the national budget that will threaten the long-term health of Social Security and Medicare. Because this is the price that the Republicans are demanding that I pay in order to extend the middle class tax cuts, all of the tax cuts will expire on December 31—under the law passed by the Bush administration.”

I’m sure your speechwriters, pollsters, and strategists can come up with something better (and didn’t you once say that you were a better speechwriter than your speechwriters?) than I came up with while lying in bed last night. But come up with something.

* All figures, unless otherwise noted, are from the Tax Policy Center. These figures also assume extension of the AMT patch. Note that these figures exclude the impact of making permanent the repeal of the estate tax (a permanent repeal is assumed in both scenarios); including that impact would skew the benefits even more heavily toward the rich.

** Of course, it is President Bush and the 2001 and 2003 Congresses that are increasing taxes on January 1, 2011.

*** The actual figure is probably slightly less than $880, since the Tax Policy Center’s analysis also includes extension of the AMT patch, so some of the $880 is due to the AMT patch, and some of it is due to extending the Bush tax cuts. Extending the AMT patch does not benefit the very rich (since they are above the AMT threshold in any case), so all of their benefits are due to extending the Bush tax cuts.

Update: The Huffington Post put this up on their front page (linking to a HuffPo-hosted version of this post), which always terrifies me—what if I made a mistake? So I reread the post, and, well, I made a mistake (in the fictional speech). The Republicans don’t control the House yet, so theoretically the Democrats still have majorities in both chambers. But they still face the Party of No in the Senate, so practically speaking the Democrats cannot pass Obama’s plan on their own. I suppose it is possible they could use reconciliation to get past the filibuster, but having just suffered a crushing loss in the midterm elections, the democratic legitimacy for such a tactic would be questionable at best.
By Simon Johnson

On the Project Syndicate website, Peter Boone and I argue, with regard to the European situation in this coming week:

The Germans, responding to the understandable public backlash against taxpayer-financed bailouts for banks and indebted countries, are sensibly calling for mechanisms to permit “wider burden sharing” – meaning losses for creditors. Yet their new proposals, which bizarrely imply that defaults can happen only after mid-2013, defy the basic economics of debt defaults.

...

Given the vulnerability of so many eurozone countries, it appears that Merkel does not understand the immediate implications of her plan. The Germans and other Europeans insist that they will provide new official financing to insolvent countries, thus keeping current bondholders whole, while simultaneously creating a new regime after 2013 under which all this debt could be easily restructured. But, as European Central Bank President Jean-Claude Trichet likes to point out, market participants are good at thinking backwards: if they can see where a Ponzi-type scheme ends, everything unravels.

Like it or not, it’s time for the Europeans to decide: Who gets unlimited liquidity support because they are essentially solvent, and who has to restructure their debt – with bridge financing and help from the outside?

This will be painful and intense. The case for debt restructuring in Ireland and Greece is clear. What about Portugal and, even more controversial, Spain – and other eurozone sovereign borrowers?

For our complete assessment, please see the Project Syndicate column. Here is the full link: http://www.project-syndicate.org/commentary/johnson14/English

Why Our Tax Code?

By James Kwak

In honor of the deficit commission, Ezra Klein is running a number of posts about the commission’s proposals and our tax code, including one about the mortgage interest tax deduction. Although this is often defended as a middle-class tax break, on a percentage-of-income basis it mainly benefits
people between the 80th and 99th income percentiles; above that they make so much money that they can’t buy big enough houses to keep up. (On a dollar basis, of course, the correlation between income and tax savings is perfect.)

This should not be surprising, since like any itemized deduction (a) it’s worthless if you have a small house and take the standard deduction instead, (b) it’s proportional to the size of your mortgage, and (c) it’s proportional to your tax bracket. Klein says, “I’m not really clear why we’re giving people making hundreds of thousands a year large subsidies to buy a house, but I’m sure there’s a good reason.” I’m sure he knows the reason, but I’ll spell it out anyway.

This issue comes up occasionally in my tax class, where I have a long-running but mostly silent debate with my professor. When he asked why we have some quirk in the tax code (I forget which), I said, “It’s a political economy thing: it benefits rich people, and they have more political power.” He said something like, “Maybe, but that argument proves too much, because the rich do pay taxes, and if they really called all the shots they wouldn’t pay any taxes.” Which is a reasonable point, so I’ve mainly let the issue lie.

But if you are the rich people in a democratic society where most people believe in reduced inequality, what kind of tax code do you want? You want to start with an overall progressive structure (so the people won’t revolt), and then you want a boatload of exceptions to that structure that (a) favor the rich and (b) can be individually defended on plausible (and sometimes even reasonable) grounds. Which is what we’ve got:

- Mortgage interest tax deduction
- State and local (property) tax deduction
- Charitable deduction
- Lower rates for capital gains and dividends
- Exclusion (or tax deferral) for retirement and educational savings accounts
- Exclusion of capital gains on home sales
- Ability to donate appreciated assets to charity and deduct appreciated value without paying tax on appreciation

As I said, you can defend most of these individually without being laughed at. But the net effect is to water down the progressivity of the system without admitting that that’s what you’re doing. And instead of ordinary people revolting against the rich, this year we had (some) ordinary people revolting in favor of cutting taxes for the rich.
By Anders Åslund, Peter Boone and Simon Johnson

Last week’s renewed anxiety over bond market collapse in Europe’s periphery should come as no surprise. Greece’s EU/IMF program heaps more public debt onto a nation that is already insolvent, and Ireland is now on the same track. Despite massive fiscal cuts and several years of deep recession Greece and Ireland will accumulate 150% of GNP in debt by 2014. A new road is necessary: The burden of financial failure should be shared with the culprits and not only born by the victims.

The fundamental flaw in these programs is the morally dubious decision to bail out the bank creditors while foisting the burden of adjustment on taxpayers. Especially the Irish government has, for no good reason, nationalized the debts of its failing private banks, passing on the burden to its increasingly poor citizens. On the donor side, German and French taxpayers are angry at the thought of having to pay for the bonanza of Irish banks and their irresponsible creditors.

Such lopsided burden-sharing is rightly angering both donors and recipients. Rising public resentment is testing German and French willingness to promise more taxpayer funds. German Chancellor Angela Merkel’s hasty and ill thought out plan to demand private sector burden sharing, but only “after mid-2013”, marks a first response to these popular demands. We should expect more.

Financial crises are actually not rare, and the rules for their resolution are clear. The fundamental insight is that huge amounts of financial losses, of seemingly real value, need to be distributed across creditors, debtors, equity holders and taxpayers. The first step is to bring the current budget deficit under control to achieve a primary balance, which both Greece and Ireland are now attempting. The second is to attract sufficient emergency funding, which the IMF and the EU essentially have done. But in neither Greece nor Ireland is that sufficient. They still have unaffordable debt burdens. Therefore, one more measure is needed, namely a reduction of the public debt.

The public debt can be contained in two ways. The first and preferable option is that the state never nationalizes private bank debt as Ireland has done. For Ireland, this opportunity has probably passed, but other countries should be warned not to make the same mistake. Kazakhstan’s refusal last year to bail out its major banks, despite strong demands from the senior creditors of these banks, has proved a far more successful path. Banks can and should go under if they have failed. The state should only defend small and medium-sized depositors.

If the state has taken on too large debt, sovereign default is the natural outcome. In their excellent book This Time Is Different, Carmen Reinhardt and Kenneth Rogoff argue that 90 percent of GDP is the highest sustainable level of public debt for a developed country. This limit is not absolute, but there is little reason to believe that Greece and Ireland would belong to the exceptions. As Germany and France so sensibly, though perhaps not very cautiously, have argued in public, the
EU needs a facility for sovereign debt default.

Sovereign defaults are always contentious, but they don’t need to end in catastrophic financial collapse. This is especially so in Europe, as Lee Buchheit and Mitu Gulati have argued in a well-read paper on “How to Restructure Greek Debt,” because over 90% of these debts are issued under domestic law. Troubled nations, as part of their rescue plans, can and should introduce legislation that permits a qualified majority of creditors to change terms on outstanding sovereign and bank debt, while protecting bank deposits. Such rules could, for example, require 2/3 of non-protected creditors agree to a restructuring plan. This reduces the risk that holdouts can prevent a deal from being reached, but still gives creditors clear powers to negotiate terms.

Well-planned debt restructuring will not cause a systemic financial collapse. It is misleading to draw parallels from the chaotic liquidation of Lehman Brothers for the outcome of debt relief in Europe. The direct impact of debt relief for Greece, Ireland and others is easily measured and managed. The debtors and creditors are well known.

If Greece’s reform program included a write-down of 50% (in net present value) on its debts, and they received an additional 20% of GDP in bridge financing over the next three years, its debt burden in 2013 would be a comfortable 80% of GDP. As Greek debt already trades below face value, the total additional losses to creditors could amount to 35% of debt, or approximately 100bn euros. Ireland is smaller so total costs should be less. This debt relief could be conditional on successful implementation of IMF monitored programs, similar to traditional Paris Club debt restructurings. Fears that debt relief could spark panic selling and contagion in other debt markets can be arrested through temporary interventions by the ECB, and the EU needs to publicly declare strict criteria when debt restructuring may occur.

Opponents to debt relief for Greece and Ireland are wrong to think that Europe’s current strategy makes Europe safe from systemic collapse. The implied risk of default on Spanish, Italian and Portuguese debt rose sharply during the last month as concerns over Ireland and Greece spread, and this in turn caused yields on related bank debts to soar. The potential economic time bombs left in Europe’s periphery are growing. They can and must be resolved. Otherwise the economic and political risks might become overwhelming.

Anders Åslund, Senior Fellow at the Peterson Institute for International Economics; Peter Boone, associate at the Center for Economic Performance, London School of Economics and principal, Salute Capital Management; Simon Johnson, Senior Fellow at the Peterson Institute for International Economics and Professor MIT Sloan.
I recently read a frightening 2008 post by David Pogue about the breakdown of homemade DVDs. This inspired me to back up my old DVDs of my dog to my computer (now that hard drives are so much bigger than they used to be), which led me to install HandBrake. The Handbrake web site includes this gem:

“The Law of Software Development and Envelopment at MIT:
Every program in development at MIT expands until it can read mail.”

I thought of that when I heard that Facebook is launching a (beyond) email service.

(The side benefit of this project is that now I get to watch videos of my dog sleeping whenever I want to.)

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By Simon Johnson

The conventional wisdom is that we face a serious budget problem, ballooning debt and political deadlock that prevents any semblance of progress either in the short term or over the next 20 years. “The sky is falling — cut everyone’s wages, slash Social Security, buy gold!” summarizes the mood of this midterm moment.

But step back and look at American public finances from any angle — historical, comparative with other nations, from Mars — and the picture is very different. We have a simple economic problem — we need to fix our tax system, irrespective of how much revenue we want from it. And we continue to face the central American political problem of the last 200 years: how much inequality are we willing to accept as reasonable and fair?

On Sunday, The New York Times invited everyone to weigh in on the deficit, posting a deficit puzzle that lets you make spending cuts and tax increases in an attempt to wipe out the deficit by 2040. I accept the invitation.

The key technical point is this: our tax system stinks. That much you have probably figured out — think back to how you felt on April 15 — but most likely you only encounter the tip of the iceberg (unless you are a tax professional). In terms of what we tax and how we tax it, almost every
dimension of government revenue feels as if it were cobbled together in the early 20th century (which it was) and never properly modernized.

At some level a clunky government revenue system reflects sensible American reluctance to pay tax, as well as the deep political polarization that we have always had about the size of government. (Anyone interested in how we arrived at this point should read Steven R. Weisman’s “The Great Tax Wars”; let me note that Mr. Weisman is a colleague at the Peterson Institute and also the editor of Daniel Patrick Moynihan’s letters.)

We’ve reached the point where modernization of our system is long overdue. It is relatively easy to raise significant revenue without having significant distortionary or discouraging effects. The New York Times budget exercise does not encompass the full range of tax reform — blame the chairmen of the bipartisan deficit reduction commission for not fully putting this on the table — but nonetheless you can find some solutions without higher rates, as I have.

The carbon tax proposal in the Times chart is too modest. Over the next 20 years we could phase in something much more ambitious, and reducing our dependence on imported oil would be a major contribution to national security. The “national sales tax” idea is a bit vague; a properly designed value added tax, which protects poorer people by rating essentials at zero, would be better.

I’m not in favor of raising rates generally, but as my proposed budget shows, I do raise tax rates for the highest paid and wealthiest people. The process of job polarization in the United States looks set to continue — the people at the top of the educational attainment ladder are going to do very well; others not so well (this is why median wages haven’t increased). Even the Peterson Foundation — not a left-wing group — points out that the richest are paying less tax today.

Note, however, that I’m less sanguine than even most self-proclaimed “fiscal hawks” about our current budget situation. Consequently, I would eliminate all the Bush tax cuts, and this substantially takes care of our short-term projected deficit. On my joint Web site with James Kwak, he makes the case regarding why this would also be good politics for President Obama. No one who claims to be focused on fiscal responsibility should want these tax cuts, we have said previously in this space.

My proposal takes $2 trillion from the budget deficit by 2030. Personally, I would go even further (with more comprehensive tax reform). By refusing to reduce risks around big banks, we continue to carry big contingent liabilities — the crisis of 2008-9 pushed up federal debt by 40 percentage points of gross domestic product, and the same thing will happen again.

We need a margin of fiscal safety (and to fix the banks, but that is not going to happen – talk to your politicians about that). For more on these points, see my testimony to the Senate Budget Committee in August.
There are some obvious spending cuts — even the Pentagon is willing to cut back on programs for weapons that are no longer a top priority.

We also need to control Medicare costs, irrespective of anything else. Again the fiscal commission and The Times do not lay out all the options, but from the numbers ($560 billion by 2030) you can see how important this is. It’s a tough problem — and don’t think about just shoving these costs (or the qualified people) back onto private health insurance; that’s just another way to ruin the economy. Either health-care costs become an ever-increasing share of G.D.P., without limit — which is not possible — or someone is going to be squeezed. We’ll see if that will be beneficiaries, payers (insurers) or providers, but those are your choices.

My final proposal is a 50/50 split between spending cuts and tax “increases,” but I do not endorse any cuts to Social Security. Again, think about job polarization and the hollowing out of middle-income jobs from this economy — mostly from the effects of technology but reinforced by the likely effects of trade. This problem is common to most of the industrialized world, but almost every other nation is better at buffering the effects with transfers.

We do this a little with unemployment insurance, and you’ll see the effects in terms of the numbers claiming disability insurance. But for most, Social Security is the only transfer program we have that works. (For the historical background on how the government came to provide this and other forms of social insurance, see David Moss’s “When All Else Fails”; the United States has generally only acted when the degree of perceived injustice became acute.)

Highly unequal countries tend to become unstable and dangerous places. How unequal do you want the United States to become?

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

By James Kwak

One of the things I can’t stand about the corporate world is the tendency of senior executives to say things that they wish were true, without verifying whether they actually are true or not. Perhaps my favorite example of all time is Stan O’Neal’s internal memo from mid-2007:

“More than anything else, the quarter reflected the benefits of a simple but critical fact: we go
about managing risk and market activity every day at this company. It’s what our clients pay us to do, and as you all know, we’re pretty good at it.”

But here’s another good one from Barbara Desoer, head of Bank of America’s home loan division (to Bloomberg):

“We believe that our assessment shows the basis for past foreclosure decisions is accurate. We have good processes and good controls.”

And apparently she’s sticking with this line. This week she told Congress, “Thus far we have confirmed the basis for our foreclosure decisions has been accurate.”

Well. She might want to have her people read the newspaper. There was the Sun Sentinel story about a man who was foreclosed on by Bank of America, despite not having a mortgage . . . with anyone. Or she might try talking to some of the other people appearing before Congress. Adam Levitin, in his testimony today, says this (p. 21):

“Many foreclosure complaints are facially defective and should be dismissed because they fail to attach the note. I have recently examined a small sample of foreclosure cases filed in Allegheny County, Pennsylvania (Pittsburgh and environs) in May 2010. In over 60% of those foreclosure filings, the complaint failed to include a copy of the note. Failure to attach the note appears to be routine practice for some of the foreclosure mill law firms, including two that handle all of Bank of America’s foreclosures.”

And this is without even looking for examples, just stuff I’ve blogged about before or happened to be reading this afternoon.

Now, if you want lots of details about how the banks and their lawyers are flouting the rule of law, there are better blogs than this one. As a member of the reality-based community, I just want to register my indignation at the corporate world’s disdain for, well, reality.

Oh, and do you know what Barbara Desoer says is her best quality in that Bloomberg article? Common sense.

Update: My outrage at Bank of America actually distracted me from my original point. If you want a readable, comprehensive, but not too long overview of the legal issues involved in the foreclosure scandal, read Levitin’s testimony. It’s excellent.
By Simon Johnson

Ireland will get a package of support from the EU and the IMF. Will the money and the accompanying policy changes be enough to stabilize the situation in Ireland or more broadly around Europe? Does it prevent Ireland from restructuring its debt – or move the Irish (and other parts of the European periphery) further in that direction?

And who gains from the delay and mismanagement we continue to see at the highest European levels?

This is complicated economic chess within Ireland, across Europe, and at the international level. In my Bloomberg column this morning, I suggest we look several moves ahead, recognizing the underlying political dynamic:

There is a much more general or global phenomenon in which powerful people cooperate to build an economic model that provides growth based on a great deal of debt. When the crisis comes, those who control the state try to save their favorite oligarchs, but there aren’t enough resources to go around

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Here is the present problem: It’s not just the Irish elite that is under pressure and struggling to sort out who should be saved. It’s also the European bankers who funded them.

If the Europeans continue to fight among themselves, regarding who bears what losses – and who has to face what kind of public accountability – which other countries gain on the global stage?

Who has the ready money available to recapitalize the International Monetary Fund, if needed? And it will be needed if Spain comes under serious pressure.

Who understands the strategic concept that piles of “reserve currency” can give you great political leverage? It is hard to find such thinking among today’s generation of American politicians.

And who is already playing international economic chess at the highest level?

China.

This guest post is contributed by Mark Paul and Anastasia Wilson. Both are members of the class of 2011 at the University of Massachusetts-Amherst.

In some cultures asking how the kids are doing is a colloquial way of asking how the individual is faring, acknowledging that the vitality of the younger generation is a good metric for the well-being of society as a whole. In the United States, the state of the kids should be an important indicator. Young workers bear the significant burden of funding intergenerational transfer programs and maintaining the structure of payments that flow in the economy. Today, the kids’ outlook is almost as bleak as the housing market; they are unemployed, underwater on student debt, and out of luck from a reluctant political system.

Currently, even after a slight boost in jobs growth, unemployment for 18-24 year olds [correction: should be 18-19 year olds] stands at 24.7%. For 20-24 year olds, it hovers at 15.2%. These conservative estimates, using the Bureau of Labor Statistics U3 measure, do not reflect the number of marginally attached or discouraged young workers feeling the lag from a nearly moribund job market.

The U3 measure also does not count underemployment, yet with only 50% of B.A. holders able to find jobs requiring such a degree, underemployment rates are a telling index of the squeezing of the 18-30 year old Millennial generation. While it appears everyone is hurting since the financial collapse, young adults bear a disproportionate burden, constituting just 13.5% of the workforce while accounting for 26.4% of those unemployed. Even with good credentials, it is difficult for young people to find work and keep themselves afloat.

If companies are unwilling to hire bright young college graduates even at a relatively low salary and minimal benefits, will they ever be willing to hire anybody at all?

Jobs aren’t the whole story. Recent college graduates, those in the labor force with the freshest batch of knowledge and skills, are currently underwater and sinking fast with unprecedented student loan and personal debt. Average student debt for the class of 2008 was $23,200, an increase over four years of about 25%, meaning that students are knee deep in negative equity between their educational investment and actual earnings.

Between inflated student debt and the lack of available jobs for qualified graduates, students are defaulting at an all time high level of 7.2%. From 2008 to 2009, student debt defaults jumped about 30% to $50.8 billion. This earning-to-debt gap not only hurts lending institutions, but also may
affect students’ future abilities to borrow – a significant hurdle in our credit driven economy.

If student debt and job stagnation continue, younger workers will face real structural unemployment (as opposed to the fake kind that had been suspected by some economists, but was recently debunked by the San Francisco Fed). The more time these young workers spend unemployed and underemployed, the greater chance for future structural unemployment due to deteriorating human capital.

High debt, high defaults, and low family earnings will prevent many students from finishing college at all. High unemployment for those who do manage to graduate with a degree will create barriers for those unable to start their careers. As economists have shown, most current deficits can actually be attributed to the decrease in tax revenues - a debilitating trend that will continue without well-targeted action.

In order to combat such structural problems, the need for investment in education and jobs is clear. This investment will act as an insurance policy against persisting future structural unemployment and subsequent government revenue declines. This investment can take the form of direct funding for public higher education, increased financial aid to students, and expanded federally guaranteed loan and grant programs. As many states have slashed and burned public higher education budgets, as in Massachusetts, federal attention should be directed towards this crisis. The 2009 stimulus funding provided only two years’ worth of support to sustain public higher education in the Commonwealth, where universities have historically been a top priority. The need for a long-term restructured investment plan in public higher education is obvious, not just in Massachusetts, but the other forty-nine states as well.

At the same time, insurance against the impending doom of climate change could be taken out in the form of a green jobs bill, providing work and an outlet for innovation for recent college graduates. As Robert Pollin and Dean Baker have suggested, long-term investments in rebuilding a green energy industrial base, complete with manufacturing and R&D, could revitalize the entire economy if funded as part of a 10-year plan to the tune of $50-100 billion. Such investment could create 660,000-1.3 million jobs per year – the kind of growth that seems to have escaped our collective memory.

Green collar industry would naturally target the young workers who are up to date on the high-tech nature of green jobs, and much research and development would, as with most budding industries, take place at academic research institutions like public universities – a two-for-one stimulus in both jobs and education.

In order to solve future structural problems in the United States and ensure a future for the sandwich generation, fiscal policy focused on educational and job growth is crucial. While deficit hawks may squawk about the costs, the burden of repayment is on younger people. Without adequate education and careers for students, we will never be able to balance the budget. In the long run, it makes more fiscal sense to create jobs and collect tax revenue than to rely on a model
that merely waits for the private sector to invest.

While the political feasibility of such a measure is questionable, the incentives are there no matter on what side of the aisle you may sit. Jobs investment will improve employment. Education will increase productivity (and profits too), increasing tax revenues from businesses and personal incomes and helping balance the budget. Crisis is not the time for austerity, and these types of investments in the viability of the U.S. economy should be done when money is at its cheapest.

In a dire job market, facing imminent climate change, and lagging aggregate demand, keeping the younger generation afloat will inevitably be a decision to sink, swim, or at least throw out some life jackets.

**Will Ireland Default? Ask Belgium**

By Simon Johnson

On the face of it, Ireland seems poised on the brink of default. Its debts are very large relative to the size of its economy, most of this money is owed to foreigners and – unless there is an unexpected growth miracle – the country will struggle to pay its debts in full for many years to come.

Yet all the indications are that, as part of the historic rescue package to be introduced this week by the European Union and the International Monetary Fund, Ireland will not default on or otherwise restructure its most substantial debts. Why not?

To be clear, Ireland owes a huge amount of money to the outside world. In the best scenario, Ireland’s government debt is likely to stabilize at more than 100 percent of gross national product (G. N. P.); in the worst scenario, with greater real estate losses and a deeper recession, this level could reach 150 percent.

That’s a higher number than you see in many news reports, in part because officials are still focused on gross domestic product, a misleading statistic in the Irish case, as Peter Boone and I have been arguing in this space for some time. (Update: some news reports are currently using a higher number for Ireland’s debt, implying that the country owes 10 times its GDP; this is based on misreading the statistics regarding off-shore financial transactions that are run through Ireland. This misunderstanding will be cleared up when the Ireland-IMF-EU package is announced.)

At least 20 percent of Ireland’s G.D.P. is from “ghost corporations” that have little or no real activity
in Ireland. Corporate taxes are set at 12.5 percent, but leading global corporations are able to construct complicated schemes involving other offshore tax havens that reduce their effective tax rates to the low single digits.

The Irish insist that raising the corporate tax rate would not generate additional revenue – effectively acknowledging the point that this part of the economy cannot be taxed as part of the anti-crisis policy mix. You will know that reality has finally set in when all the relevant numbers are presented relative to G.N.P., not G.D.P.

After the I.M.F. finishes going through the Irish books, we will all need to redo our projections (remember the data revisions that came to light in Greece under similar circumstances). But for now we stand by our previous assessment regarding the likely trajectory of Irish budget deficits – in the region of 10 to 15 percent of G.N.P. for this year and next.

So why not restructure some of this debt, particularly as much of what the government will owe is actually debt taken on by overgrown and careless Irish banks?

The government has indicated that it will force a restructuring of some subordinated, relatively junior debt – for at least for one prominent bank, Anglo Irish, this may amount to paying 20 cents in the euro. This debt by itself is too small to make a difference, but why not apply the same principle to other categories of borrowings?

The most obvious answer is: Ireland’s European partners do not want this to happen, because it would expose the really bad decisions made by pan-European banks and their regulators over the last decade and create potential fiscal risks in other euro-zone countries.

Jacob Kirkegaard, my colleague at the Peterson Institute for International Economics, points out that the claims of foreign banks (in the 24 countries reporting to the Bank for International Settlements) on Ireland “are at over $500 billion — three times the scale of total claims against Greece.” (The underlying BIS data he uses can be seen here: http://www.bis.org/statistics/provbstats.pdf#page=90; start on p.90.)

German banks in particular lost their composure with regard to lending to Ireland – although British, American, French and Belgian banks were not so far behind. Hypo Real Estate – now taken over by the German government – has what is likely to be the highest exposure to Irish debt.

But look at loans outstanding relative to the size of their domestic economies (using the BIS data on what they call an “ultimate risk basis”).

German banks are owed $139 billion, which is 4.2 percent of German G.D.P. British banks are owed $131 billion, or about 5 percent of Britain’s G.D.P. French banks are owed $43.5 billion, which is approaching 2 percent of French G.D.P. But the eye-catching numbers are for Belgium, which is owed $29 billion – in the relatively small Belgian economy, this accounts for around 5
percent of G.D.P.

Given the prevalence of off-shore banking in Ireland, these numbers may overstate the true liabilities. But still, Belgium is already on the hook, according to the Bank for International Settlements, for 18.3 percent of G.D.P. as a result of “general government contingent liabilities arising from ‘crisis assistance’ to financial institutions” (again, see Jacob’s note.) The last thing it – or the rest of the euro-zone – needs is a fiscal crisis arising from commitments to support its banks after an Irish default.

Belgium’s overall fiscal picture is not good, its political stability is far from assured and its underlying social fissures would surely not be helped by a further dose of severe austerity. (According to Eurostat’s latest numbers, the Belgian budget deficit was 6 percent of G.D.P. in 2009 and its debt was 96.2 percent of G.D.P. at the end of last year; to be fair, Belgium has an established tradition of being able to survive with high debt levels.)

In addition, Ireland’s European creditors reckon, if they can just hold on for a few years, perhaps there will be a recovery in asset values. But real estate prices rose dramatically in Ireland over the last decade – quadrupling by some measures. And fiscal contraction – either higher taxes or lower government spending or both, as negotiated with the I.M.F. and E.U. – is unlikely to help the residential real estate market (so far most of the damage has been in commercial real estate.)

It is true that Irish mortgages are “recourse” — that is, you can’t just turn in the keys and walk away from a property as you can in many parts of the United States. On the other hand, Irish residents can leave the country – moving to Britain or the United States is a well-established tradition for many families. And how can an Irish lender enforce debts when someone has emigrated?

Eventually, Ireland will need to restructure its debts. How soon and how completely it does this will have major implications for the rest of Europe.

Many countries were exposed to the potato blight of the 1840s – it was a global affliction — but Ireland was unusually dependent on this one crop (a phenomenon known as monoculture). The result was famine and emigration; the population never returned to its pre-1840s level.

Many countries experienced debt-based property booms over the last decade fueled, in part, by reckless cross-border lending. Ireland again proved to have something of a monoculture; this is the origin of its extreme vulnerability and an awful decade to come.

This time, will the global disease continue to spread as banks elsewhere get bailouts that allow them to become even bigger and more dangerous? Will we see immediate ramifications in other euro-zone countries, such as Belgium or others?
And will the same underlying problem continue to grow in such a way that it can ultimately bring
down the United States – as Peter Boone and I suggested here in March?

This blog post appeared this morning on the NYT.com’s Economix. It is used here with permission.
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The Eurozone Endgame: Four Scenarios

By Peter Boone and Simon Johnson

In the aftermath of the Irish bailout, the German proposal for a future sovereign and/or senior bank
debt restructuring mechanism within the eurozone makes complete political sense to the electorate
in stronger European countries. They do not want to write “blank checks” to weaker countries and
to out-of-control financial institutions going forward; creditors to countries that run into trouble will
face likely losses.

While the details of this “burden sharing” approach remain to be hammered out (after Sunday’s
announcements), there is no way for German or other politicians to backtrack on the broad
strategic principles. But once this arrangement is in place, say in 2013 or thereabouts, all eurozone
countries will (a) be able to sustain less debt than has recently been regarded as the norm, and (b)
become vulnerable to the kinds of speculative attacks in debt markets that we have seen in recent
weeks – to reduce funding rollover dangers, they will all need to lengthen the maturity of their
outstanding debt.

The end point is clear. Last week the markets began to work backwards to today’s debt profiles;
major disruptions still lie ahead.

Ultimately, there will be a eurozone will greater shared fiscal authority, a common cross-border
resolution authority for failed banks, and likely greater economic integration. But there are four
scenarios regarding who ends up in that eurozone – and how we get there.

First, as officials hope, the IMF bailouts for Greece and Ireland may work – by stopping the panic
and reassuring the investors that there will be enough growth to make even those debt burdens
sustainable. This seems most unlikely, particularly given what we have seen of the IMF package for
Ireland so far.

In this scenario, everyone can continue to stay inside the eurozone. The debt profiles of Greece
and Ireland would remain vulnerable, as would slow growth in Portugal and whatever Spanish
banks are hiding in their so-called “stress tests.” Germany agrees to foot an open ended bill because its leadership becomes scared of the consequences. The ECB buys a lot of bonds, one way or another.

Second, there is the current market consensus that a package of IMF-European Union support for Portugal and perhaps Spain would truly stabilize the situation. This consensus is fragile – and perhaps more wishful thinking than anything else – but likely to motivate official efforts in the week ahead. But this is what we call the Maginot Line Illusion, i.e., an idea that ignores the potential for trouble to jump to other potentially weaker eurozone countries, such as Italy, France or Belgium.

In this scenario, Greece probably leaves the eurozone and restructures its debt. The Germans say “Greece should never have been admitted; this was the original and only mistake.” Ireland stays in the eurozone but many of its citizens emigrate. There could be significant grants from Germany and even from outside the eurozone, depending on how much fear spreads around the globe.

Third, there is the thoughtful view of Willem Buiter – currently chief economist at Citigroup and still a brilliant critic of the global financial system. In a presentation circulating last week (not publicly available), he predicts “three or more sovereign defaults in the next five years.” His logic is impeccable – once it is easier to restructure debts, the temptation is to do exactly that; the market knows this and so brings everything forward in time.

Fourth, we have the unthinkable – nicely articulated by the Financial Times’ Lex column on Friday. Divide the eurozone into “relatively prudent” and “relatively imprudent”, in terms of fiscal policy. Adjust that for the forward-looking ability to run a primary surplus (i.e., can a country run a budget surplus on a pre-interest basis, needed to pay down the government debt if under pressure.) Adjust this further for off-balance sheet losses incurred by a country’s banks in the “extreme stress” scenario that begins with the default on senior Irish debt guaranteed by the sovereign – another “Lehman moment”.

Now the eurozone (more likely, some kind of Neue Deutsche Mark, NDM) becomes Germany, the Netherlands, Austria, Finland, and a few smaller countries. Italy is out – even though northern Italy should remain, two currency zones within one country probably does not make sense (sorry Catalonia).

In this scenario, France is the interesting case. Does France leaving the eurozone break the Franco-German alliance that has underpinned European integration since its inception?

Even this extreme scenario is not so bad for political stability and economic recovery. The weaker peripheral countries will be damaged for a generation, but European integration is about more than attempting to share a currency between countries with divergent fiscal policies and no convergence in productivity.

The NDM area will do well; in fact, growth there is already strong – they will probably want to raise
By Simon Johnson

Congressional Republicans are apparently intent on a big showdown with Elizabeth Warren, who is currently building up the new Consumer Financial Protection Bureau (CFPB).

This is very good news for the White House, if they use this opportunity wisely.

Some Republicans seem to think that Ms. Warren is about “big government” or “intrusive regulation”. But this is not the case – Elizabeth Warren’s approach is much more appealing and already popular with almost everyone on right and left: Transparency.

Look carefully at Ms. Warren’s September speech to the Financial Services Roundtable and think about how this plays as a broader political message.

Her political principle is clear and completely compelling:

“…the best way, in my view, to strengthen those middle class families is to find solutions that are deep and lasting, that strengthen the markets, and that will create a robust, competitive consumer credit industry that works for families, not against them.”

Her economic approach is also right on target – the market should work for the consumer:

“I come to Washington as a genuine believer in markets and a genuine believer that the purpose of regulating the consumer credit market is to make that market work for buyers and sellers alike: a level playing field where the best products at the best prices win. When it works, the market is an ally to consumers. And, when it works, the market rewards those lenders who offer the best value to their customers.”

…”

“When I talk about functioning markets, I’m not using the word “market” as coded language for a return to the Wild West where companies use deception to pick off every consumer they can get in their sites. A free market is one where consumers have the ability to
In other words: stop already with the cheating of people. This is not good for our economy, not good for business as a whole, and definitely not good for American families.

“But credit agreements have gotten long and complicated. In fact, there’s a new epithet: fine print. I understand that some of you call it “mice type.” Where I come from, nobody calls fine print, hidden fees and surprise penalties “negotiated contract terms” or “innovations.” On a polite day, my brothers in Oklahoma call that kind of stuff “garbage.””

This is the specific deliverable: Get rid of the fine print.

“An AARP poll earlier this year showed that 96 percent of Americans over 50 surveyed want to put an end to the fine print in their credit agreements. Just in case you missed the point, 91 percent felt strongly about that. 96 percent? These are your customers.”

And they vote. This is exactly the terrain onto which the White House should seek to shift the political debate.

Don’t play the Republicans’ game by agreeing to debate “big” vs. “small” government. This is a complete illusion – just watch the favors that businesses will seek from Republicans on the Hill; not all of these appear “on the government’s balance sheet”, to be sure, but you can talk to the anguished people of Ireland about how exactly supposedly “pro-business” (and definitely pro-big bank) policies end up costing the taxpayer a lot of money. (Or just look at how the financial disaster of 2008-09 ended up costing us 40 percentage points of GDP, measured in terms of the increase in our national debt – directly because of how the financial sector ran its customers and itself into the ground.)

The political debate should begin with documenting business practices that are misleading and duplicitous, wherever they occur.

We need transparency and accountability in the financial sector – and in all other parts of our economy. Elizabeth Warren is exactly the right person to lead this charge, in the first instance from the CFPB.

She should be nominated by President Obama to head the agency. The fight for her confirmation would make her ideas clear to millions. Let’s see which senators exactly are willing to argue against greater transparency.