To: The Las Vegas City Council

Mayor Oscar Goodman
Mayor Pro-Tem Gary Reese
Coucilwoman Lois Tarkanian
Councilman Steve Wolfson
Councilman Stavros Anthony
Councilman Ricki Barlow
Councilman Steven Ross

From: Todd Farlow
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In Lieu of oral comments; Citizen Participation, Council Meetings of 5/05 & 5/19 2010

Request: That the City Council conduct a feasibility study into the establishment of a City-owned and operated commercial bank.

Arguments for the request:

I am a capitalist. As such, I believe that banks serve as the matrix of capital in the advance of ideas and social progress. In recent years the major banks have failed on their part of the social contract in both practice and deed. In fact, it was reveled on the PBS program Bill Moyer's Journal that the nation's largest bank, (Citi-Bank) made it part of their mission statement to transform the United States Government into a plutocracy, ..using that very term. (Reference #1) One of the methods of achieving this goal was to make major contributions to both parties running for key offices so that no matter who won the seat, the bank could push through legislation that the bank would draft. The act is not treason in that treason requires the intent of violent overthrow. The campaign financing method has recently been held legal by the Supreme Court. (Reference #2) How this will play out is unknown. The social fabric of the country has been held in place by a sense of fairness seemly ingrained into the American psychic. The breaking of this social contract is causing a disconnect and reconsideration of the social structure. (References 3 & 4) The United States now has a distribution of wealth comparable to China's. (Reference #3) The major banks cannot be trusted. Their books are cooked (Reference #5), loaded with toxic assets and still hold 97% of the derivatives market leveraged at 78-to-1.(Reference #6) As this mess plays out there are more disasters on the horizon, chiefly in commercial real estate and there is big trouble ahead in the private-equity market. (Reference #7) There is a good possibility that one of these could trigger a "fat-tail" event and cause the collapse of our social contract altogether. (Reference #8) At the moment, we have socialism for the very wealthy and capitalism for the rest, and there may be hell to pay if the people's sense of fairness and trust is not restored. I do not think the idea of democratic socialism as practiced in Europe would work in the United States, as we are too diverse and success-minded. It is in no way assured that it will even work in Europe. Reference #9) The sacrifice of time and money to

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by Todd Farlow

move ideas into successful businesses is what has set this country apart, but all business depends upon capital and the financial industry and it's regulators have dropped the ball. Add the enablers to the mix and its had a devastating effect on local and state governments. Banks are holding foreclosed real estate in inventory so as not to declare a loss on it. They can do this and still post record profits by borrowing from the Federal Reserve at a fraction of a percent interest and using the money to buy Treasury notes paying around 3.5%. The only thing required to keep this fiasco going is that the U.S. Government continue to run up HUGE deficits and this, in turn, has lead to all manner of misadventures.

Adding to the chaos is the change taking place in labor itself. We are better for it but machines and new building methods will almost guarantee that we will never see low unemployment rates again. (Reference # 10) To keep American capitalism from collapsing into god-knows-what, there will be more rounds of Federal stimulus monies. As J.K. Galbraith points out, the U.S. as a true sovereign cannot go bankrupt, (Reference #11) and J.R. Hummel explains why. (Reference #12) The problem is that the major banks aren't "banking". (Reference #13) Exacerbating the situation is that government monies are being "parked" in some of the same institutions that are causing the grief. Bank of America is a good example.

I propose that the City of Las Vegas look into the feasibility of creating it's own bank such as the State of North Dakota has done. (References #14 & 15) Las Vegas has always been the place to start over and has a history of attracting people with entrepreneural spirit. I suggest an "enterprise" bank that would provide a full range of services to incubate start-up companies and educate, train and shepherd small businesses until they have enough acumen and credit standing to be accepted by a commercial bank. It should serve as a matrix between investors and ideas. It should provide factoring and insurance services and provide enterprise education in high schools and community colleges.

Money can be created in several ways, but chiefly by leveraging. By leveraging funds a City-owned bank could create the finances needed to pay for and promote the goals of local governments.

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time. Without any minority support, the majority must move to its own ideological center rather than the electorate's, in an effort to secure every possible vote from within.

In such a situation, the president must try "to hold together a governing coalition by slaloming: veering from left or right to center and back." This is what President Barack Obama has been trying to do for more than a year. "Every zig toward the center offends the party's base (too many compromises!), and every zag back toward the base upsets the centrists (he's just too extreme!), and the president looks weak and inconsistent," Rauch writes.

Mode 2 works in reverse. When the parties share power, they are forced to compromise, bringing legislation closer to the country's ideological center in the process. The president can position himself as the central mediator between the party ruling Congress and his own base. Governing will be easier for the president, and his popularity will improve.

Rauch says that recent history bears this out. In periods of unified government (Bill Clinton's first two years and George W. Bush's middle four), "Congress leaned too far left or right, the president was dragged off center, the country became bitterly polarized, independents grew disgusted, and the voters soon switched to Mode 2," Rauch writes. That may be just what happens in the upcoming midterm elections in November. Unlikely as it may seem, if Congress flips Republican, President Obama may stand to benefit.

POLITICS & GOVERNMENT

The Paradox of the Welfare State

THE SOURCE: "What Is Living and What Is Dead in Social Democracy?" by Tony Judt, in *The New York Review of Books*, Dec. 17, 2009.

AMERICANS MAY COMPLAIN about health care, schools, and crime, but they seem to have "difficulty even *imagining* a different sort of society," contends historian Tony Judt. Their thinking is biased by what Judt calls "economism"—"the invocation of economics in all discussions of public affairs." He calls for a "moral critique of the inadequacies of the unrestricted market."

The "propensity to avoid moral considerations" in our public discourse is "an acquired taste," Judt writes, and one that developed relatively recently. Classical economists of the 18th century were greatly interested in what Adam Smith called "moral sentiments." Smith wrote that the "disposition to admire, and almost to worship, the rich and the powerful, and to despise, or, at least, to neglect persons of poor and mean condition . . . is . . . the great and most universal cause of the corruption of our moral sentiments." He could have been describing America today, Judt despairs.

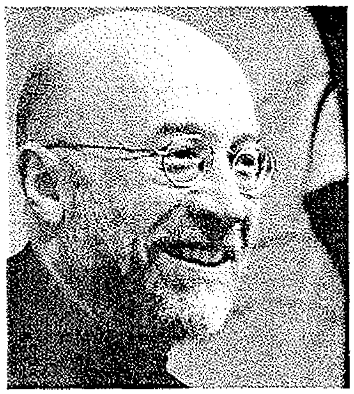
Ironically, this "corruption" stems from the success of the welfare state. Social democratic policies enacted in the years following the Great Depression and World War II built the middle class and reduced inequality. People began to feel that the safety nets provided by the state were no longer necessary. "The paradox" of welfare states in America, as well as Europe, "was quite simply that their success would over time undermine their appeal."

By the early 1980s, Washington was at work undoing the welfare state, beginning with Reagan-era tax and employment reforms, followed by the deregulation of the financial sector, and culminating with welfare reform, in the shape of the Personal Responsibility and Work Opportunity Act of 1996 ("a more Orwellian title would be hard to conceive," Judt says). A "cult of privatization" promised efficiencies and profits that have proved illusory. Inequality grew, and today the United States has a distribution of wealth comparable to China's.

Judt says that the provisions of the welfare state—such as support for the needy and investments in public transit—do not always have to make economic sense in order to make "social sense." The benefits are not in dollars, but in the value of having a "good society"—which undeniably comes at a price. He heralds a new era of social democracy, designed to reassure people in what is an "age of insecurity." Imagining what such a society would look like shouldn't be so hard—the "remarkable achievements" of the 20th-century welfare state are an excellent model.

Talking With Tony Judt

The author of *Ill Fares the Land* on social democracy, trains and our desiccated ethical vocabulary.



JOHN R. RIFKIN

In October historian Tony Judt gave a lecture at New York University, where he is a professor and director of the Remarque Institute, on the fate of Western social democracy. The talk was remarkable not only for what was said but for how. Judt—who has advanced amyoptrophic lateral sclerosis (ALS), or Lou Gehrig's disease, and is paralyzed from the neck down—had memorized his talk, which he delivered from his wheelchair, his face partially obscured behind the breathing apparatus he calls his "facial Tupperware." Several months later he published a version of the talk in The New York Review of Books, *and when that caught fire he expanded the talk into a short book.* Ill Fares the Land *(Penguin Press; $25.95) traces the history of the postwar state in the United States and Europe, showing how rampant privatization, an excess of individualism and the worship of the market have produced unacceptable levels of inequality. Disparaging both extreme left- and right-wing solutions, Judt makes a case for social democracy, advocating a new conversation about our collective responsibilities as citizens, humanists and human beings. —Christine Smallwood*

You write that *Ill Fares the Land* is for young people. When you were young, was there a book that did for you what you want this book to do for others?

It was a very different world. I was born in 1948, so I'm a '60s kid, and in the '60s everyone talked all the time, endlessly, about socialism versus capitalism, about political choices, ideology, Marxism, revolution, "the system" and so on. I grew up in a world where the social democratic state was the norm, not the exception. So when I think of books that really influenced me, they were books that went against the grain of those times. They were, for example, Orwell's *Homage to Catalonia*. Or Arthur Koestler's *Darkness at Noon*. Or the book edited by Richard Crossman called *The God That Failed*, which was a collection of six essays, all by ex-communists, all by guys who were still on the left, by and large, people like Koestler, or Ignazio Silone in Italy, or Richard Wright, who were disillusioned communists but still committed leftists in one respect or another. Those are the kinds of books that influenced me, and it was because they were written by people with a very strong voice who were not necessarily simply opposing everything that existed. They were neither conservative nor revolutionary, but autonomous voices. What I'm trying to do in *Ill Fares the Land* is to write not from an ideological or political position but against the grain of current thought.

Christine Smallwood, a writer in New York, is a former associate literary editor of The Nation.

You still have faith that the liberal state can be restored to health. But is there a reason that there has to be a liberal state? The "liberal state" itself is a historically specific creation, isn't it?

Look, just as nothing has to be, nothing has to disappear. Things didn't need to be the way they are, but there's no law that says they cannot survive or cannot recover. We don't live in a world of fixed historical laws that says the—as you describe it—liberal state was born at a particular time, lived and died, and that's what we're stuck with. But there are reasons why some things are much harder to retain, to invent, to reinvent than others.

There are two different considerations here. The first is the social reality of the social democratic state—the activist state, if you like—with collective responsibility across space and time for other people's interests. That is almost inevitably going to survive in one form or another. In my world it was pretty clear which aspects of my parents' world would survive into ours; in my kids' world, it's not at all clear which aspects of my world will survive into theirs. With globalization, with the fear of economic change, with the insecurities that the twenty-first century is going to bring, which are going to be far greater than those of the twentieth, the level of insecurity is going to have the paradoxical effect of throwing people back on the state much more, looking to it for everything from medical protection to physical protection to job guarantees to protection against outside competition and such. So the question is not going to be, Will there be an activist state? The question is going to be, What kind of an activist state?

And that brings us to the second consideration, which is how we think about it. We've emerged from a twentieth century which we've learned to think of as a kind of seventy-year running battle between the over-mighty state and the wonders of individual freedom. Extreme forms of individualism versus extreme forms of collective enforced authority. Roughly speaking, Stalin versus the tea party. That's a caricature of the twentieth century. But it's one that we have to a large degree internalized, so when people think of the political choices facing them, they think of them in terms of maximized individual freedom versus maximized collective repression, or power or authority or whatever. And then they think of any changes with one or the other, regrettable compromises with freedom or so on. We need to change that conversation so we can think of the state not as some external creature that history has imposed upon us but simply as a way of collective organization that we chose to place onto ourselves. In that sense the liberal state either has a future or it doesn't, but it really is up to us.

So democracy becomes a real problem, right? If people continue to choose inequality, what can you do?

Democracy has always been a problem. The truly attractive features of the Western tradition that we accidentally—and it really is accidentally—get the benefit of are the rule of law, liberalism and tolerance, all of which are virtues inherited from predemocratic societies, whether they were based in eighteenth-century Anglo-American aristocratic individualism or nineteenth-century European forms of a type of developed postfeudal legal state. Democracy comes last. Democracy is simply a system of selection of people to rule over you. And it's not accidental that everyone is now a democrat. The Chinese are for democracy. George Bush was for democracy. The Burmese believe in it; they just call it something slightly different. South African whites believed in democracy; they just thought it should be arranged differently for blacks. Democracy is a dangerously empty term, and to the extent that it has substance, and the substance consists of allowing people to select freely how they live, the chance that they will choose to live badly is very high. The question is, What do we do now, in a world where, in the absence of liberal aristocracies, in the absence of social democratic elites whose authority people accept, you have people who genuinely believe, in the majority, that their interest consists of maximizing self-interest at someone else's expense? The answer is, Either you re-educate them in some form of public conversation or we will move toward what the ancient Greeks understood very well, which is that the closest system to democracy is popular authoritarianism. And that's the risk we run. Not a risk of a sort of ultra-individualism in a disaggregated society but of a kind of de facto authoritarianism.

You've been working on a study of the modern railway. What are you learning?

I've for many years fantasized about writing a study of the place of the railway in the modern world, economically, topographically, in town planning, in the creation of space and the idea of time, in movies and literature and so on. I knew some of this stuff in the abstract, but I've learned much more concretely about the astonishing degree to which the railway—literally the railroad, trains, the whole economy it created—changed our world in ways that planes, cars, the Internet, even electricity maybe didn't quite match. The very notion of society existing in terms of classes, in terms of collective life, public and private space, cities and the relationship between city and country; the idea of time, of time as something that organizes us rather than we organizing it—these were all railway creations. If you try to imagine the world that existed before 1830, before the first railway line in England, between Manchester and Liverpool, it's quite literally unimaginable. It takes an effort of will to realize that in Roman times the sense of distance was about the same as it was in 1780, let's say. For most of human history, people never came into contact, or did very rarely, with either someone who was not born where they lived or some artifact that was not made either by them or by someone they knew or in the town in which they were born. But within one generation they are living in a world that makes today's globalization look like nothing in terms of the transformation. That's the work of the railway, much more than anything else in the world, and that's what I want to try to capture in the book.

You've spoken to the *Guardian* about how your condition has led you to write with the aid of a memory palace. Can you walk me through it? What kind of furniture is there?

Sure. Well, first, it's not a memory *palace*—I'm not a sixteenth-century Italian aristocrat. It's a memory *chalet*, because I like Switzerland. In my mind's eye, it's a building about the size of a large Swiss house or a very small Swiss hotel, with cute little gables and pretty little red and white flowers in the windows. I go in, and on the left, let's say, there will be a little room where you keep skis and boots and sleds, and on the right there will be a toilet. And in the next room there'll be a kitchen on the left, and on the right there'll be a little dining area or something. And maybe if you go to the hallway toward the back, there's a large living area. There will be a staircase in the back, which is where they are in Swiss chalets, going up to the bedrooms.

Now, I'm lying in bed—it's not much fun, lying there thinking about this thing, a particular chapter, or story, memoir or complicated argument—and I think, How is it going to be organized? The first part will go down with the ski boots, on the left. Then I go into the kitchen and there's a series of drawers, and in each of the drawers there will be, maybe with the silverware, the introduction. The main argument will be with the china, or in the pasta cupboard—the pasta cupboard might be convenient because it will make me think of substance. And so it goes until I've got the whole ground floor, roughly speaking, packed away. And then I'll go through it once more. And the next morning, while I'm waiting to be set up, given my coffee, washed and so on, I go through the mind of the Swiss chalet again, and in each of the relevant bins and rooms and so on I will easily remember what goes where. If I'm lucky and the thing was worth preserving, which it may not be, when my assistant, Eugene Rusyn, comes in I can say, I've got an idea for a little memoir; can you jot down some points before we start writing? And that's how it works.

Where is religion in *Ill Fares the Land*? You remark that "most people" have dispensed with it, but certainly in the United States it hasn't gone anywhere.

One of the things that struck me over the course of the last twenty-five, thirty years, probably because I got very involved in Eastern Europe, was that there was no reason or principle why religion and what I think of as a sort of socially responsible state should be remotely incompatible. What's missing from public conversation and public policy conversation is precisely a sort of moral underpinning, a sense of the moral purposes that bind people together in functional societies. And part of the attraction of someone who otherwise didn't appeal to me in the least—like, say, Pope John Paul II—was how he managed to connect with young people. Whether it was in Eastern

Europe or Latin America or wherever, his was the sense of an absolutely, unambiguously, morally noncompromising view about what is right and what is wrong. It seems to me that we need to reintroduce some of that. We need to reintroduce confidently and unashamedly that kind of language into the public realm. And not expel it, so to speak, into church for Sunday. It's not only on Sunday that some things are right and some things are wrong.

In my second marriage I was married to someone who was a very active American feminist and very anti the anti-abortionists. I would find myself listening to her angrily say that abortion is a good thing and these people are crazed fascists and so on, and I'd think, This conversation is taking the wrong turn. What you have here are two powerfully held moral positions, incompatible socially, backed by different perspectives. But it's not a question of one of them being immoral and the other being moral. What we need to learn to do is conduct substantive moral conversations as though they were part of public policy, so that abortion is a terrible thing and a necessary thing, and both statements are true. You see what I mean? With decent medical services and proper prophylactic facilities and real contraceptive education and proper support for young people, particularly in poor areas, abortion would not be nearly as big an issue as it is. Then you could learn to think of difficult moral issues as part of social policy rather than just screaming at each other from either side of a moral barrier. Then we could reintroduce what look like religious kinds of conversations into national social policy debates.

I come from a very religious background, and it seems to me that people on the left are so embarrassed about the language of morality that they've ceded the ground to the right.

I totally agree. I think it's a catastrophe for both sides. What it means for the left is that it's got no ethical vocabulary. What it means for the right is that it smugly supposes that it's got a monopoly on values. Both sides are completely wrong. There used to be a tradition of left-wing ethics, Orwellian if you like, or pre-Orwell. I'd like to say parenthetically that I come out of a sort of secular dissenting Jewish background, but one with some of the same thoughts of the old dissenting churches—Christian, Jewish—of the late nineteenth and early twentieth centuries, in which there was a natural correspondence of social values and ethical criteria. And the divorce between them has been one of the disastrous results of the last half-century. I'd love to contribute to re-forming that link.

Is there anything else you'd like to say?

Your first question, about young people, is true, but I'd enter a caveat: *Ill Fares the Land* is a book for anyone who cares about the collective world that we live in and are making for ourselves, whether we like it or not. It's not a book written with a view to presenting a solution to a fixed set of problems, saying, Read this and do that. It's a book deliberately designed to ask what's wrong, how should we talk about it, how should we think about fixing it. And that's all that it should be. Anything more than that would close off conversation. I want to open it up. ■

Learning to Love the Healthcare Bill

It took time for people to appreciate Medicare and Social Security, but they came around.

by KATHERINE S. NEWMAN AND STEVEN ATTEWELL

Will the passage of healthcare reform provide a boost to Obama's popularity and the chances of holding on to a Democratic majority in the fall? The question preys on the minds of many progressives, even those who find the White House lacking in zeal for causes on the left. The alternative would mean polarization, at best. At worst, it could be a return to the dark days of Republican rule from which we have escaped all too recently. To be sure, the failure to pass the healthcare bill would have been a catastrophe. The measure was a significant test for the base of the Democratic Party. Could a leadership that stumbled badly on the banks, mortgage cramdowns and credit card regulation actually provide something of tangible benefit to the working people of this nation?

Before this victory, Obama's position was not unlike that of Roosevelt as he approached his first midterm in 1934. FDR stabilized the banking system through a more conservative series of reforms (the banking holiday, the Emergency Banking Act and Glass-Steagall) than many had hoped for; he succeeded in passing legislation that was supposed to address the recession systematically (the Agricultural Adjustment Act and National Industrial Recovery Act roughly paralleling the stimulus bill in terms of what they were supposed to accomplish). But these policy victories notwithstanding, FDR hadn't addressed the needs of the more than 10 million unemployed. His answer to this critique came in the fall of 1933 with the creation of the Civil Works Administration, which under the leadership of Harry Hopkins succeeded in directly employing 4.3 million people between Thanksgiving of 1933 and 1934. While the CWA was only a temporary program, it sent a mes-

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No More Phony Accounting

Cooked books helped produce the collapse—and the fakery continues.

BY FRANK PARTNOY

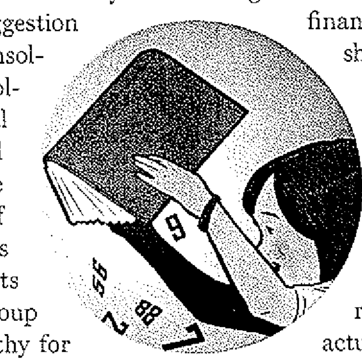
Phony books played a central role in the financial crisis, but recent financial-reform proposals say virtually nothing about accounting. This omission is shocking. Simply put, the balance sheets of major banks were, and still are, fiction. Financial institutions did not, and still do not, disclose their true liabilities and true risks. If they had, we might have averted this crisis. Until Congress adds accounting to its agenda, and until financial statements reflect reality, financial reform will not work.

Accounting can be boring, so let me begin with a startling illustration. Below is a balance sheet, a real balance sheet, of a real company. Look at the numbers and try to guess which company it might be. While you are doing so, remember that the market declined sharply in 2007, crashed in 2008, and recovered by more than half in 2009. For most companies, the previous four years were a roller-coaster ride in which they soared, plunged, collapsed, and finally recovered (some). Now here's that actual balance sheet:

	2006	2007	2008	2009
ASSETS	$1,884	$2,188	$1,938	$1,857
LIABILITIES	$1,765	$2,074	$1,797	$1,702
EQUITY	$120	$114	$142	$155

These numbers look rock solid. Assets declined a bit since 2007, but so did liabilities. Overall, the net equity of this company has been rising steadily, apart from a minor blip in 2007. If these numbers are accurate, they represent a conservative and steady company, one that miraculously weathered the recent financial storm. Who might it be? Perhaps Starbucks? Or Wal-Mart?

In fact, this is the balance sheet of Citigroup. Yes, *Citigroup.* These numbers do not even hint that the value of Citigroup's business went from a quarter of a trillion dollars to nearly zero during this time. There is no indication that Citigroup suffered massive losses in 2007 and 2008 and then a major post-rescue recovery in 2009. There is no suggestion that Citigroup was insolvent, or close to insolvent, until the federal government promised to guarantee more than $300 billion of its debts. Instead, this balance sheet depicts an illusion of Citigroup as consistently healthy for all four years. The accuracy hasn't improved recently, either: The latest numbers in the chart are from a financial filing dated Feb. 26, 2010, just a few weeks ago.



This balance sheet is fiction.

And Citigroup is not alone. The balance sheets of every major Wall Street bank are just as fictitious. They do not reflect trillions of dollars of swaps. They do not include many subsidiaries, which banks use to avoid recording risks. Instead, the banks' exposure is off-balance sheet. Their financial statements do not show many of their actual liabilities. The dirty secret of the markets is that the financial statements of major Wall Street banks are false.

Consider the recent revelations about Lehman Brothers. Before its collapse, Lehman not only hid its derivatives liabilities from view but also used a scheme known as "Repo 105" to remove tens of billions of dollars of debt from its balance sheet. In March, after the Lehman bankruptcy examiner revealed some details about the scheme, members of Congress finally promised hearings into these false financial statements. Yet the legislative financial-reform proposals still do not require that balance sheets reflect reality. Indeed, they do not address balance sheets at all.

Some industry insiders will tell you that a formal balance sheet is no big deal. Supposedly, sophisticated analysts can uncover the data that is missing from the balance sheet, in footnotes to the financial statements. But even an investor who waded through the hundreds of pages of footnotes in a corporate filing would not have found deals like Repo 105 or the real exposure of swap liabilities at any major bank.

More important, the balance sheet remains a crucial document for financial regulation. Fools or not, regulators rely on financial statements. The balance sheet is the basis for numerous legal rules, including a bank's core ("Tier 1 and Tier 2") capital requirements. Investors look to balance-sheet numbers for a range of purposes. Until financial statements reflect something closer to the actual assets and liabilities of our major financial institutions, regulators will not be able to assess the risks of these institutions, the markets will not properly function, and another crisis will be just around the corner.

ABUSIVE OFF-BALANCE-SHEET accounting triggered the daisy chain of dysfunctional decision-making by misleading investors, markets, and regulators. False accounting facilitated the spread of the bad loans, securitizations, and derivative transactions that brought the financial system to the brink of collapse. Bankers became predisposed to narrow the size of their balance sheets, because they knew investors and regulators use the balance sheet as an anchor in their assessment of risk. Bankers used financial engineering to make it appear they were better capitalized and less risky than they really were—and still are.

Wall Street lobbyists argue that fixing off-balance-sheet transactions would be too complicated. But these accounting problems are neither new nor complex. Indeed, Congress confronted similar problems in 1933, when it investigated the accounting shenanigans of the 1920s, such as the far-flung schemes perpetrated by Ivar Kreuger, known as "The Match King," whose securities were the most widely held in the world. During the New Deal, Congress' straightforward remedy was to require ample disclosures and to enforce stiff penalties when companies failed to accurately disclose their risks. That approach cleaned up the financial system back then, and we need to adapt the same core principles now.

Transparency and enforcement are simple but crucial reforms, and most people understand their importance. If the balance sheets of Citigroup or Lehman or American International Group or Bear Stearns had been accurate, they would have shown massive exposures to opaque financial instruments and securities and derivatives based on sub-prime mortgages. But they did not. The details are complex, but the problems posed by off-balance-sheet accounting are quite obvious to ordinary Americans. What if the next time you wanted to borrow money, you didn't have to list most of your debts? What if Congress let you keep your credit-card bills and mortgage liabilities hidden from view? How much would you borrow? How would you spend or invest that borrowed money? How much risk would you take? The answers do not require an MBA. Common sense tells us that if we let people hide their debts, they will borrow more than they should, at the wrong times, for the wrong reasons.

Lynn Turner, the former chief accountant at the Securities and Exchange Commission, and I recently proposed a straightforward fix to the off-balance-sheet problem: Require that balance sheets reflect reality. We even included proposed language for Congress to adopt. It is just one paragraph (with a second paragraph anticipating some of the objections Wall Street might raise). It wouldn't take long for Congress to add this language:

"The Securities and Exchange Commission, or a standard setter designated by and under the oversight of the Commission, shall, within one year from the enactment of this bill, enact a standard requiring that all reporting companies record all of their assets and liabilities on their balance sheets. The recorded amount of assets and liabilities shall reflect a company's reasonable assessment of the most likely outcomes given currently available information. Companies shall record all financings of assets for which the company has more than minimal economic risks or rewards."

That's it. With this simple reform, Congress could mandate that companies report all of their assets and liabilities. Companies that omitted material assets and liabilities from their balance sheets would be subject to civil liability in the same way companies generally have been exposed to private rights of action for material misstatements. This is not a radical proposition: It is precisely what Congress did in 1933 and 1934, in response to that era's financial crisis.

Accounting reform is absent from today's debate, not because it is partisan but because concentrated Wall Street powers wield more influence than the diffuse interests of Main Street. In principle, Democrats and Republicans agree that market capitalism requires transparency, or it will not function properly. But it also is clear that transparency reduces the profits of Wall Street banks. They do better operating in the dark, in shadow derivative markets that are hidden from public view. Accounting reform is a test of whether members of Congress will respond to hundreds of millions of dollars of campaign and lobbying expenditures by banks or to the needs of most investors and taxpayers.

Average Americans understand what can happen if people are permitted to lie about their debts. The rest of us include all of their liabilities on our financial statements. Banks should, too. TAP

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Sand in the Gears

The case for a tax on financial speculation

BY ROBERT WEISSMAN

Buy a cup of coffee in Manhattan, and the sales tax is 8.875 percent. Buy a share of Exxon on the New York Stock Exchange, and the tax rate is just a hair more than zero. Like other double standards that benefit high finance, the zero tax rate on financial transactions both reveals and reinforces Wall Street's massive power and privilege.

But now a growing movement is coalescing around the idea of a financial-speculation tax, as an opportunity to confront Wall Street politically, shrink the bloated financial sector, diminish dangerous speculation, and raise significant sums of money to meet priority needs. The movement is drawing support among consumer, labor, and financial-reform groups associated with Americans for Financial Reform and also among climate-change and global-health campaigners, who hope a speculation tax can generate revenues for targeted purposes. The idea is attracting interest among congressional leaders and has the affirmative support of British Prime Minister Gordon Brown, French President Nicolas Sarkozy, and other European leaders.

There are numerous possible variants of a financial-transaction tax. Nobel economist James Tobin famously proposed a tax on currency transactions, and some advocates focus on currency trades. Even Larry Summers, as a young economist, wrote a scholarly paper supporting a Tobin tax as salutary "sand in the gears"—and that was before the explosion of derivatives trading. Today's leading proposals envision a sales tax will be offset by reduced trading volume.

In Congress, Rep. Peter DeFazio of Oregon has introduced the Let Wall Street Pay for the Restoration of Main Street Act, which would impose a .25 percent tax on buying and selling a stock and a corresponding amount on other financial transactions. DeFazio's bill has 29 co-sponsors. On the Senate side, Sen. Tom Harkin of Iowa has introduced a similar measure, The Wall Street Fair Share Act, with three co-sponsors. But the interest on the Hill goes far beyond the numbers co-sponsoring the proposals. Nancy Pelosi has spoken positively of the idea, and other Congress members consistently raise it as a potential funding source for jobs and transportation initiatives.

In the United Kingdom, the idea of a speculation tax has caught the public's imagination thanks to a cleverly branded "Robin Hood" campaign and a humorous Internet video featuring actor Bill Nighy. U.S. campaigners hope that importing the verve of the Robin Hood campaign will enable the speculation tax to break through the clutter of confusion around seemingly technical and arcane financial-reform proposals. With public anger at Wall Street still boiling hot, and massive domestic and global needs remaining unfunded, this is the right political moment to win a speculation tax. TAP

Robert Weissman is president of Public Citizen.

Coalition of the Unwilling

Diverse individuals and businesses are hurt by the financial system. Can they coalesce?

BY HEATHER MCGHEE

In theory, financial reform should dismantle the same deregulated system that produced toxic credit-default swaps *and* toxic credit cards. But on every aspect of financial reform except perhaps for basic consumer protection, the necessary structural reforms won't be passed in 2010. If the greatest financial-market meltdown in history couldn't spur deep, structural reform, what will?

The battle-within-a-battle for consumer protection offers some clues. A new federal regulator dedicated solely to keeping unfair and deceptive financial products out of Americans' hands was what the advocacy community wanted and, more or less, got. What advocates didn't get has filled the pages of this special report.

Why was consumer protection so different? Partly, it's not quite as opaque as Wall Street's insider stock-in-trade. Derivatives, proprietary trading, off-balance-sheet reporting, hedge-fund regulation, and the like aren't exactly the stuff of kitchen-table conversations. Even so, when polled about the shadowy "casino economy," likely voters in swing districts responded viscerally, with four to one in favor of more regulation. Yet consumer protection hasn't just fared better because it is simpler. It has benefited from a simple truth: Taking down the system requires a revolt from within—a revolt of customers. And we need more such revolts.

With trillions of dollars in economic power lined up to protect the deregulated status quo, the best dissidents have turned out to be the purported beneficiaries of the system. On consumer finance, the revolt happened years ago when middle-class borrowers broke up with their lenders over credit-card abuses, deceptive mortgages, and ridiculous overdraft fees.

Of course, the banking industry quickly learned the lesson. To make the case against regulation of derivatives, the bankers didn't show their faces, even though the big five mega-banks control 97 percent of the market and have $78 in derivatives exposure for every $1 held by actual businesses. Instead, they lined up the corporate buyers of traditional and defensible derivatives such as options and futures to hedge against changes in the price of supplies. These so-called end users from Apple to John Deere fronted for bankers and lobbyists and argued that aggressive reform would hurt ordinary corporations. Suddenly, the reformers' argument that exchange trading would bring price transparency and benefit the real economy had nowhere to go.

Americans for Financial Reform, the umbrella advocacy coalition established to promote real reform, quickly organized an impressive array of other end users who had been burned by speculative price spikes in commodities like food and energy. But it was nearly impossible to break through in the media or Congress once other corporations had presented a united front with bankers.

ACHIEVING FINANCIAL REFORM that's more than just tinkering around the edges will require a revolt of many more unsatisfied customers. One unorganized potential base: the dozens of state and local governments who bought aggressively marketed interest-rate swaps on bonds during the boom and are now being hammered on both ends by Wall Street. On the one end, the Street caused the Great Recession, which is decimating tax receipts and community budgets. On the other, the same bankers have refused to renegotiate outrageous interest-rate spreads even though, as a result of the crisis they created and due to taxpayer largess, their borrowing costs are next to zero.

Banks like Goldman Sachs and JPMorgan Chase will collect over $1.25 billion from cash-strapped school systems, towns, and states over the deals in 2010. The insult of having to pay an investment bank money for nothing while it cuts city services stirred the Los Angeles City Council into action in March. Faced with a $19 million annual payment to Wall Street, the council voted to move nearly $30 billion in city business away from any company that refused to renegotiate a derivative deal. A number of states are even considering their own "public option"—cutting out the private sector altogether and opening their own banks to fund infrastructure and lend to citizens. This is exactly the type of "end user" revolt that, once organized, could pave the way to a real financial-reform agenda.

Though largely focused on health care and the Employee Free Choice Act for the past year, organized labor is beginning to tell a broader story about how productive, jobs- and goods-producing American businesses have suffered in an economy dominated by finance. (Finance overtook manufacturing as America's largest sector by profits in the 1990s.)

"We want real growth in America, not just growth in the debt markets," says Heather Slavkin, a senior policy adviser at the AFL-CIO. With Wall Street's current business model, those two are increasingly incompatible. Unregulated hedge funds and private-equity funds bought up over 3,000 American companies during the leveraged buyout boom. The buyout model—use Wall Street–financed debt to purchase companies, extract equity, and leave companies highly vulnerable to loan defaults—has put millions of American jobs at risk. Experts estimate that half of the bought-out companies will go bust in the coming years. Such a reckoning could add the executives and workers of America's private-equity-owned companies to the ranks of Wall Street's dissatisfied customers.

Pitting the banking business against the rest of American business could create just the opening progressives need, as the U.S. Chamber of Commerce understands perfectly. That's why it insists that financial reform isn't aimed at big banks—it's aimed at "businesses that have little to do with consumer finance," such as the local butcher who lets customers buy ground chuck on a tab.

Besides proving how out of touch the chamber is with modern life, its multimillion-dollar "local butcher" ad campaign showed how toxic the real targets of financial reform are—even within their own trade group. Fortunately, health-care reform has battle-tested new progressive groups to represent the actual butchers of America (who may not extend credit anymore, but they certainly need it, and fairly priced). Small businesses that are priced out of affordable health care did not join big businesses in opposing health reform, and organizations like Business for Shared Prosperity, the MainStreet Alliance, and Small Business Majority will be essential to dismantling the business case for predatory finance.

Another improbable ally in the structural critique of the banking system is the Independent Community Bankers of America, which supports breaking up the large banks and reinstating the Glass-Steagall Act. True, the ICBA lobbied hard to exempt their members from the proposed Consumer Financial Protection Agency, but when the agenda moves on to truly dismantling "too big to fail," count on them to be there.

In sum, there is a huge, majority coalition of unhappy customers of Wall Street. This is the prime constituency for real reform. The trillion-dollar question, of course, is where the White House will be. President Barack Obama got a taste of the fruits of progressive leadership when he won health reform. But on banking, at least for now, the Bush administration's mission to preserve the system in 2008 has ended up being the same mission of the Obama administration's reform plans in 2010. But the system—highly leveraged, opaque, overconcentrated, and dominated by shadow market players and practices that didn't exist even a decade ago—is fundamentally not worth saving. In the years ahead, we will need many more voices to convince the powers that be of that truth. TAP

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Simplifying Securitization

With a better system, the economy can have plenty of credit without the outlandish risks and excess banker profits.

BY JANE D'ARISTA

The packaging of loans into securities is one of the financial innovations most deeply implicated in the financial crisis. It is not only closely associated with the explosive growth of sub-prime mortgages and credit derivatives but responsible for transforming the U.S. financial structure from a system based on prudent bank lending to one based on highly speculative securities markets.

The creation of a market for mortgage-backed securities came about as a response to the banking crisis of the inflationary 1970s. Lending institutions were making 30-year fixed-rate mortgage loans but financing them with short-term deposits at newly deregulated market interest rates. As inflation increased, banks lost money on their mortgage portfolios. In response, Congress called on the government-sponsored secondary mortgage-market enterprises (known as GSEs)—Ginnie Mae, Fannie Mae, and Freddie Mac—to support savings institutions and small banks by buying their low-interest-rate mortgages. At that time, the GSEs were the only entities converting loans into bonds, which were fairly straightforward and not divided into securities with different degrees of risk, known as "tranches."

By the close of the 1970s, however, a second and larger inflationary spike overwhelmed the safety valve provided by the GSEs. And in the 1980s, private competitors to Fannie, Freddie, and Ginnie began offering far more complex securitized products. In principle, this innovation allowed a lender to go on making fixed-rate mortgages, shedding risks to third-party investors willing to bet on the future movement of interest to Islamic law. Berman misinterprets Ramadan's scholarly citations to Qaradawi and misses the countless places in Ramadan's writings where he distances himself from Qaradawi, sometimes vociferously, albeit not by name.

Berman's big mistake is to suggest that Ramadan invites an "esoteric" reading that shows his failure to break decisively with the Muslim Brotherhood. By a decisive break, Berman means an open, bold declaration. But the real break is right under his nose.

Ramadan's entire corpus consists of a steady and unyielding assault on Muslim insularity, self-righteousness, and self-pity. He has been unceasing in his pleas for Muslims to abandon their fearful mistrust of all things infidel and stop clinging to the life raft of the symbols of Islamic religiosity. The single dominant theme in his writings is a rejection of legal formalism and dogmatism in Islamic ethics. The grandson of the man who taught Muslims that "the Qur'an is our constitution" spends page after page denouncing that outlook as superficial and harmful. Ramadan doesn't need to reject Islamic criminal law line by line or to criticize Islamist figures by name because he is playing a bigger, longer-term game of moving Muslims beyond their traditional conception of the Law. This is not lost on conservative Muslims, for whom Ramadan is a very touchy subject. If not for his genealogy, they would have hung Ramadan out to dry long ago.

Ramadan, it is true, is neither a Hirsi Ali nor a Salman Rushdie, who are both self-declared apostates. They have left the community and call to those trapped within. In contrast, Ramadan is an *internal critic*, to use Michael Walzer's term. Internal critics push their community to change, but they do so from within it, out of love. To follow Berman is to say that Muslims in their mainstream intellectual and religious traditions do not deserve internal critics. They deserve only apostates. As communism in another era had its Arthur Koestlers and Leszek Kolakowskis, so Islamic orthodoxy must have its Rushdies and Hirsi Alis. Islamism is so tainted by Shariah, the Brotherhood, and violence that we must view it as nothing more than another Stalinism or fascism and draw lines in the sand. According to Berman, we must tell Muslims, "Either you are pro-Enlightenment or you are soft on stoning."

But that is both blatant nonsense and pernicious groupthink. We also need to recognize the task of internal critics. As there were socialists who sought to recover a humanist young Marx as a response to Stalin, so there can be Muslims who try to use the resources of their faith to reconcile it with modernity. In short, instead of either Hirsi Ali or Ramadan, we can have both.

Berman wants us to see Ramadan as a gateway drug, but gates open both ways: Why might Ramadan not be a gateway from orthodox Islamism to something else? To be sure, he doesn't confront the darker practices of the Prophet and the Law or of his own grandfather. But while Ramadan's biography of Muhammad, for example, may be banal and artless, it is not pernicious. Internal criticism is not only about facing up to harsh realities; it is also about creative and fruitful forgetting. It is about inventing new stories about your tradition that open up a different future.

Are all good and decent people destined to converge on the same secular, Enlightenment principles? Is every encounter with strangers about sizing them up as friends or enemies once and for all? How should outsiders seek to influence the moral struggles of other communities, especially religious ones? These are not easy questions, and Berman is hardly the first to blink in the face of them and choose comforting pieties over curiosity, complexity, and humility. **TAP**

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BOOKS

The Private-Equity Time Bomb

THE BUYOUT OF AMERICA: HOW PRIVATE EQUITY WILL CAUSE THE NEXT GREAT CREDIT CRISIS BY JOSH KOSMAN, Portfolio, 280 pages, $26.95

BY ROBERT KUTTNER

You may recall a front-page *New York Times* story from last October about Simmons Bedding Company. The 133-year-old Wisconsin firm was entering Chapter 11 bankruptcy, having been bought and sold by private-equity companies four times since 1986. The private-equity owners sucked out capital from a perfectly viable operating company and loaded it up with debt so that they could extract more money; when it collapsed under the weight, they took it into bankruptcy. Altogether, the private-equity owners made an estimated $750 million in profits, while the company's debt went from $164 million in 1991 to more than $1.3 billion in 2009. In the bankruptcy, bondholders alone will lose some $575 million, and more than a thousand workers have already lost their jobs.

What happened to Simmons has happened to hundreds of other companies, and worse is yet to come. Some iconic American brands are now speculative playthings of private equity, which has become a Madoff-scale scam, albeit a perfectly lawful one. The practice is not only legal but encouraged by our tax, securities, and bankruptcy laws. By giving financial engineers a deduction against taxes otherwise owed for the interest paid on borrowed money, the tax code creates an incentive for private-equity artists to rely heavily on borrowing. Neither tax nor regulatory law distinguishes between productive borrowing and abusive borrowing, and the bankruptcy code allows a corporation to wipe off old debts, no matter how abusively or corruptly they were incurred.

And because the securities laws are designed primarily to protect investors rather than the integrity of the system, private-equity companies are exempt because they do not have shareholders in the usual sense of the term. The companies' shares do not trade on exchanges, though they have limited partners who are akin to shareholders.

Private equity, as financial journalist Josh Kosman explains in this brilliant and necessary book, is misnamed. It might better be named private debt. Unlike a bona fide venture capitalist, a private-equity company does not add net equity capital. Mainly, it adds debt, which in turn finances windfall extractions, often at the expense of the operating company, as in the case of Simmons. "The idea that PE firms put cash into companies was a widely held misconception," he writes. The victims are workers (whose wages, benefits, and pensions are squeezed), suppliers, creditors, communities, and the very existence of once proud and viable American corporations. And warns Kosman, as these companies increasingly enter bankruptcy, private equity will cause yet another credit crisis comparable to the sub-prime disaster.

The fable told by the private-equity industry, Kosman explains, is that many companies are poorly managed and sources of cost-savings could be wrung out by new management brought in by new owners. Alternatively, the story holds that their share price undervalues the parts of an enterprise that could be more profitably deployed if reconfigured or broken up. But in reality, very few private-equity owners are willing to play the role of both disruptive innovators and patient capitalists. They are interested in quick windfalls. What makes the entire business model viable is that companies, or their parts, can be bought and sold several times with borrowed money, using the subsidy of a tax break on the interest each time.

If this tale sounds vaguely familiar, it's the story of the leveraged-buyout (LBO) craze of the 1980s. When the LBO business crashed and burned, Kosman explains, LBO operators rebranded their industry as "private equity," which sounded so much more dignified. Many of the players, such as KKR, are the same. True venture capitalists, Kosman writes, "invest in growing companies, and they maintain an active oversight role as these companies grow and change." Private-equity firms, by contrast, make their big bucks on buying, loading up the company with debt, and selling—sometimes to each other so that tax breaks can be used each time. In addition, they pay themselves exorbitant "special dividends" and "management fees," looting the cash flow that the operating company needs for its ordinary operations, not to mention investment in innovation.

As these companies increasingly enter bankruptcy, private equity will cause yet another credit crisis comparable to the sub-prime disaster.

There have been other books on abuses of the leveraged buyout game, but Kosman's is the first to comprehensively describe the modern private-equity industry as it has evolved over the past two decades, and its risks and costs to the economy. He had a particularly good perch to cover this story. Beginning in 1996, as a young journalist, he took a job for the *Buyouts Newsletter* and then at the *Daily Deal* newspaper, which covers the industry for a business audience. He knows private equity as well as any financial journalist. Over the years, he became appalled at what he was covering but stayed on the beat. "I decided to learn as much as I could about private equity to write a book about the industry aimed at a general readership," he writes.

The stories are grimly familiar. Thomas H. Lee Partners, one of the biggest private-equity firms, buys Warner Music, the world's fourth-biggest music company, and loads up the company with debt to finance the buyout and to pay itself $1.2 billion in dividends. One-third of the work force is fired. KKR, Merrill Lynch, and Bain Capital team up to buy Hospital Corporation of America, a long-troubled company with 170 hospitals. Staffing is thinned, standards erode, complaints increase. CD&R, The Carlyle Group, and Merrill Lynch buy Hertz, the nation's largest auto-rental company, putting up $2.3 billion in cash out of a $15 billion deal. The private-equity owners quickly recoup more than half of their down payment by loading up the company with even more debt. Funds for rental operations are cut by 39 percent, and Hertz's market share falls. Bain Capital, the company that made Mitt Romney rich, invests just $18.5 million in KB Toys, extracts $85 million in dividends, then takes the company into bankruptcy, stiffing employees, investors, and creditors.

Early in the last decade, private equity thrived on the same bubble that pumped up housing prices and created the sub-prime boom and the general illusion of prosperity. And the entire game was eerily reminiscent of sub-prime. Like much of the rest of the bubble, private equity's windfall gains were based on borrowed money. Buyout volume, Kosman reports, peaked in 2007, at $486 billion. Between 2000 and 2008, there were a total of 3,188 such deals. Like sub-prime, private equity was one of the schemes that generated enormous fees for Wall Street firms that arranged the takeovers and the financing. The biggest financiers, not surprisingly, were JPMorgan Chase, Goldman Sachs, and Citigroup. Most of the debt, in precisely the fashion of the sub-prime disaster, was turned into securities and bought by pension funds, hedge funds, and ordinary investors. And like the rest of the economy, private equity is facing a day of reckoning—but one that has been slightly delayed because the collapse of the overburdened operating companies is not happening all at once. Kosman reports that private-equity firms own companies that employ some 7.5 million Americans, and he estimates that half of them will go bankrupt between 2012 and 2015, leaving a trillion dollars worth of debt in their wake and costing close to 2 million jobs.

There have been efforts over the years to prohibit these abuses, and all have failed. In 1987 the chairman of the House Ways and Means Committee, Rep. Dan Rostenkowski, after congressional investigations of the first wave of LBO disasters, proposed to close the tax loophole that rewards takeovers with borrowed money. But that was the year of a stock market crash, and Congress was in a mood more to restore confidence than to reform the abuses. President Barack Obama's plan for broad financial reform has only the most minimal reporting requirements for private-equity and hedge funds. The revolving door between administrations of both parties and the private-equity industry, plus the industry's very efficient use of lobbying and campaign contributions, as Kosman observes, makes substantial reform unlikely any time soon. Kosman's contribution, in an exceptionally clear and careful book, is to shine a bright light on this little-appreciated time bomb to remind us why the current financial crisis is made up of many interconnected parts and that absent radical reform, that crisis is likely to continue detonating. TAP

BOOKS

The Ultimate Sunblock

HOW TO COOL THE PLANET: GEOENGINEERING AND THE AUDACIOUS QUEST TO FIX EARTH'S CLIMATE BY JEFF GOODELL
Houghton Mifflin Harcourt, 272 pages, $26.00

BY DAVID ROBERTS

During the 1950s, the atomic scientist Edward Teller was eager to prove that nuclear bombs could be used in construction as earthmovers, and in 1958 he won the approval of the U.S. Atomic Energy Commission for Project Chariot, a proposal to explode several multi-megaton hydrogen bombs near Point Hope, Alaska, just above the Arctic Circle. In less than two seconds, explosions equal to 160 times the power used on Hiroshima would dig a new, half-mile-long deep water harbor to help export coal.

"What objections could there possibly be to this large-scale atomic harbor-blasting project?" asked the editors of the *Fairbanks Daily News-Miner*. As it turned out, there could be objections. For instance, the Inupiats, who had been living on Point Hope for about 5,000 years, were less than enthusiastic. But progress is progress. "When we have the harbor we can create coal mines in the Arctic," Teller reportedly said, "and they can become coal miners."

In the end, the locals couldn't be sold on a harbor that would be iced in for nine months of the year. (Ah, NIMBYs, what can you do?) The Soviets, however, tested peaceful nuclear explosions until 1988. And Teller never lost his faith that Big Machines could win the day; he went on to champion Ronald Reagan's Star Wars missile-defense system.

Teller's ghost haunts journalist Jeff Goodell's *How to Cool the Planet*, an exploration of new ideas for geo-engineering, or large-scale, intentional intervention in the earth's climatic system to solve the problem of global warming. A hair-raising question hovers over these schemes: What would someone like Teller do if he had the ability and opportunity to terraform the entire planet? Would he treat all of humanity like Inupiats?

It sounds like a premise for a sci-fi short story, but in fact it's an urgent practical question. As Goodell chronicles, geo-engineering has gone from a fringe idea to mainstream discussion with astonishing speed. More scientists are getting serious about interceding directly to mitigate the worst effects if climate change gets out of hand. If they're to be believed, it won't even take very long or cost very much. We're all in Point Hope now.

A quick taxonomy is in order. Geo-engineering ideas are all over the map, and quite a few are just wacky—say, shooting a nuke at the moon to kick up a cloud of sun-blocking dust—but two basic ideas are being taken seriously.

The first is what the British Royal Society has termed "solar radiation management," sometimes known as "solar shielding." The idea is simple: If the earth is getting too warm, prevent some of the sun's rays from reaching it. According to the best available modeling, blocking just 2 percent of the sun's radiation would counteract a doubling of atmospheric carbon dioxide. Though there are a variety of ways to go about this—you may have heard about space mirrors—two have gained traction. The first and most popular involves shooting sulfur particles into the upper atmosphere to imitate the shading effect of a volcanic explosion. The particles themselves would rain out harmlessly after a few years, so the supply would have to be continually replenished with planes, blimps, or extremely long hoses. (Yes, really, hoses.) The second is brightening the tops of clouds to make them more reflective, thus deflecting more sun, which can allegedly be done by injecting them with super-fine water droplets. Unlike sulfur particles, whose effects would be global, cloud brightening would have effects on a local or regional scale.

The other frequently discussed form of geoengineering, somewhat less Dr. Evil-ish, is pulling carbon dioxide directly out of the air. One promising solution along those lines is biochar, biomass that's been pyrolized (burnt in the absence of oxygen) to form a porous charcoal that traps carbon and enriches the soil. Or there's the direct route: David Keith at the University of Calgary is building a machine that pulls carbon out by mixing air with a sodium-hydroxide spray and a bunch of other chemical processes too complicated to get into. Others have championed the idea of seeding the ocean with iron, to stimulate the growth of phytoplankton, which absorb carbon dioxide and, the theory goes, sink to the bottom of the deep ocean, thereby sequestering the carbon.

It's heady stuff, boggling in its scope and potential ramifications but almost entirely speculative. There have been few serious field experiments, so most of what's known (to use the term loosely) comes from computer modeling. Despite the fateful consequences, geoengineering remains frustratingly abstract. Readers require each rating agency to have a clearly stated methodology and appropriate compliance machinery; and both would give new legal recourse to investors. (This is the gutsiest component of the Dodd and Frank plans: The ratings agencies would no longer be allowed to make heaps of money from their quasi-official role as guardians of the line between speculation and investment, and then, when their ratings turn out to be worthless, pose as mere publishers of "opinions" enjoying the unlimited protection of the First Amendment.) But both leave the basic, thoroughly corrupt business model of the rating agencies untouched.

That is a failure of vision as well as nerve. The goal of financial reform, as Dodd, Frank, and too many others in Washington seem to conceive it, is merely to reduce the likelihood of another disaster. They must aim higher, toward a financial economy that is truly an instrument of the real economy. At the moment, America needs nothing from the financial sector more than fully functioning, trustworthy credit markets. No step could do more to achieve that result than the kind of wholesale reform of the rating agencies that is, tragically, not yet on the table. TAP

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Shadow Banking

Reforms pending in Congress would not touch the abuses of hedge funds and private equity.

BY NOMI PRINS

Despite all the noise about financial reform, the shadow banking system that helped create the financial crisis would remain fundamentally unaltered by the legislation now pending in Congress. Indeed, leveraged entities such as private-equity, venture-capital, and hedge funds get only minor regulatory attention.

These barely regulated, nontransparent bastions of speculation propagated systemic risks beyond any that could be created by the banks themselves. Whether housed at banks, created by banks, or freestanding, they exist to enable speculative risk-taking hidden from either regulatory or market scrutiny while camouflaging layers of debt and enabling the complex-securitization deals that caused the financial collapse.

Yet, neither the House bill passed last December nor the most recent Senate bill submitted by Sen. Chris Dodd does more than impose marginal adjustments on the shadow banking system. Even those measures contain loopholes so inviting that JPMorgan Chase, the largest hedge-fund manager by assets worldwide, scoffs at the notion it will be adversely affected.

Leaving Shadow Banks Intact. Under the most recent Senate bill, hedge funds managing more than $100 million worth of assets would have to register with the Securities and Exchange Commission as investment advisers. But private-equity and venture-capital funds would not. Dodd's bill leaves it up to the SEC to construct a definition for private-equity and venture-capital funds as differentiated from hedge funds. (There's no standardized definition of hedge fund yet.) Cue industry lawyers.

Loophole No. 1: Private-equity funds are financial-pyramid bottom-feeders; they buy distressed companies or assets, load them up with debt, extract near-term profit, and are gone before any collapse occurs. And since private-equity funds can both invest in hedge funds and do anything a hedge fund does (it's all a matter of how they pitch what they do to their investors), hedge funds could just change their name to avoid registration or information sharing. Dodd's bill would charge banks and any non-bank financial company supervised by the Fed holding $50 billion or more in assets to pay into an "orderly liquidation fund." But hedge, private-equity, and venture-capital funds wouldn't have to contribute.

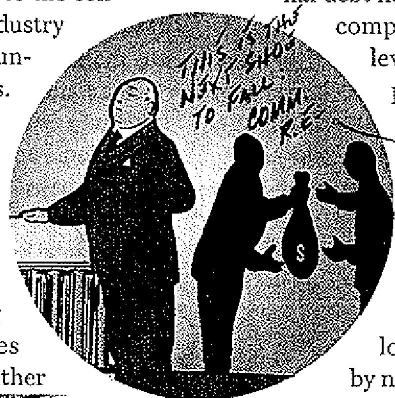
Loophole No. 2: Neither the Senate nor the House bill alters the way in which hedge and private-equity funds do business. They only minimally alter where a fraction of the funds' business *can't* be done. A collapse of all or part of the banking system due to hedge-fund or private-equity abuses would necessitate use of a resolution fund—into which shadow bankers have made no payment. They pile on the risk but don't pay for the fallout.

The Volcker Rule Minus Teeth. The latest Senate bill ostensibly adopts the so-called Volcker Rule restrictions prohibiting depository institutions and bank-holding companies from sponsoring or investing in a hedge or private-equity fund (it makes no explicit mention of venture-capital funds). A new Financial Stability Oversight Council would decide how to implement and interpret this regulation. Additionally, the comptroller general is required to conduct a feasibility study regarding a self-regulatory private-equity and venture-capital fund oversight and submit a report to the House Financial Services and Senate Banking committees within a year after enactment. Of course, a year gives lobbyists plenty of time to figure out ways to circumvent any form of regulation.

Loophole No. 3: Under the Senate bill, foreign-based firms that aren't directly or indirectly controlled by a firm organized under U.S. laws are exempted. European banks could thus expand their private-equity and hedge-fund game on our soil, thereby spreading globalized risk.

Loophole No. 4: Though large banks like JPMorgan Chase and Goldman Sachs run hedge funds, the language in Dodd's bill doesn't prohibit a bank from managing the portfolio of a *client* who chooses to invest in hedge funds. Since banks aren't required to delincate or disclose exactly what's proprietary and what's client-oriented (a major deficiency of the Volcker Rule itself), there's nothing to keep them from calling nearly every hedge-fund activity client-oriented, thereby getting around this rule.

Missing the Problem: Hedge Funds. Despite lobbyist claims to the contrary, the hedge-fund industry played a key role in the run-up to the banking crisis. It was an eager buyer and trader of the equity in toxic collateralized-debt obligations (CDOs) and other complex high-risk securities while heavily leveraging the higher-rated pieces of these securities. In other words, the industry provided the seed money to create these securities and a market for them while excessively borrowing money from the banks creating them. By doing so, the industry inflated the perceived value and demand for these securities, as well as systemic risk and leverage.



Indeed, the hedge-fund industry tripled to an estimated $1.8 trillion business between 2002 and 2008, just as the sub-prime loan and complex-securitization market was expanding. Not a coincidence.

Bear Stearns' infamous credit hedge funds were designed to leverage structured credit securities by as much as 35 to 1, enticing "hot money" investors who ultimately ran for the hills when they smelled potential losses, creating chaos in their wake. Current proposals might prohibit banks from outright owning such funds (and only if they aren't "client oriented"), but they don't constrain how the funds operate.

Private-Equity Firms Weren't Innocent Bystanders. Private-equity funds financed both mortgage-lending and real-estate-development companies, both directly and by purchasing equity in commercial CDOs. Now, they are picking up the broken pieces of those endeavors by buying failed banks and lenders on the cheap (as hedge funds go about buying cheap bank stocks in bulk).

Major private-equity firms like Fortress and the Carlyle Group are busy raising capital to buy chunks of more than $1 trillion of distressed commercial real-estate debt that lies underwater on the books of banks, insurance companies, and other lenders. Much of that original debt had been securitized in complex assets with high leverage, just like sub-prime loans were—and could ignite another crisis when defaults cumulate.

Between 2002 and early 2008, roughly $1.4 trillion worth of sub-prime loans were originated by now-fallen lenders like New Century Financial. If such loans were our only problem, the theoretical solution would have involved the government subsidizing these mortgages for the maximum cost of $1.4 trillion. However, according to Thomson Reuters, nearly $14 trillion worth of complex-securitized products were created, predominantly on top of them, precisely because leveraged funds abetted every step of their production and dispersion. Thus, at the height of federal payouts in July 2009, the government had put up $17.5 trillion to support Wall Street's pyramid Ponzi system, not $1.4 trillion. The destruction in the commercial lending market could spur the next implosion.

As long as leveraged funds bolster these markets (whether inside or outside of banks), the true value of complex securities will be unknowable and subject to extreme cycles of bubble and collapse. This time it was sub-prime; next time it could be commercial real estate, oil, or food.

The Reforms We Need. Current reforms won't deter the reckless financial engineering, investing, and inflation of values upon which leveraged funds thrive. Right now, Wall Street funds are inhaling a host of new distressed security concoctions (a k a toxic assets part II) that scoop up all the junk out there and regift it to the markets. This all operates under the radar screen.

Right now, Wall Street is scooping up all the junk out there—toxic assets part II—and regifting it to the market.

Thus it is imperative that banks with any form of leveraged fund, even if it belongs to a client, must provide detailed information to the SEC, no exceptions. Every hedge fund, private-equity firm, and venture-capital company, no matter what its size, should be required to register with the SEC and be subject to stringent reporting requirements and limits on leverage.

Private-equity firms should have to confer with regulators and make public all steps of their actions when buying and operating failed banks whose deposits are government-insured; otherwise we will maintain this unbalanced situation where banks can't own private-equity funds, but private-equity funds can manage banks.

Hedge funds should have restrictions on the percentage of securitized assets they can buy and the percentage of federally backed banks or financial firms they can own. Hedge funds currently own 6 percent of Citigroup, for example; if they dump their stock, the ripple effect could generate a need for more federal aid.

Without addressing these structural issues, shining a high-beam of transparency, and dramatically restraining the leverage and risk that these funds can take or enable, we are doomed to crash again. TAP

Nomi Prins is a journalist and a senior fellow at Dēmos. Her books include It Takes a Pillage: Behind the Bailouts, Bonuses, and Backroom Deals from Washington to Wall Street *and* Other People's Money.

GREAT POWERS and empires are, I would suggest, complex systems, made up of a very large number of interacting components that are asymmetrically organized, which means their construction more resembles a termite hill than an Egyptian pyramid. They operate somewhere between order and disorder—on "the edge of chaos," in the phrase of the computer scientist Christopher Langton. Such systems can appear to operate quite stably for some time; they seem to be in equilibrium but are, in fact, constantly adapting. But there comes a moment when complex systems "go critical." A very small trigger can set off a "phase transition" from a benign equilibrium to a crisis—a single grain of sand causes a whole pile to collapse, or a butterfly flaps its wings in the Amazon and brings about a hurricane in southeastern England.

Not long after such crises happen, historians arrive on the scene. They are the scholars who specialize in the study of "fat tail" events—the low-frequency, high-impact moments that inhabit the tails of probability distributions, such as wars, revolutions, financial crashes, and imperial collapses. But historians often misunderstand complexity in decoding these events. They are trained to explain calamity in terms of long-term causes, often dating back decades. This is what Nassim Taleb rightly condemned in *The Black Swan* as "the narrative fallacy": the construction of psychologically satisfying stories on the principle of *post hoc, ergo propter hoc.*

Drawing casual inferences about causation is an age-old habit. Take World War I. A huge war breaks out in the summer of 1914, to the great surprise of nearly everyone. Before long, historians have devised a story line commensurate with the disaster: a treaty governing the neutrality of Belgium that was signed in 1839, the waning of Ottoman power in the Balkans dating back to the 1870s, and malevolent Germans and the navy they began building in 1897. A contemporary version of this fallacy traces the 9/11 attacks back to the Egyptian government's 1966 execution of Sayyid Qutb, the Islamist writer who inspired the Muslim Brotherhood. Most recently, the financial crisis that began in 2007 has been attributed to measures of financial deregulation taken in the United States in the 1980s.

In reality, the proximate triggers of a crisis are often sufficient to explain the sudden shift from a good equilibrium to a bad mess. Thus,

THE ROT IN THE U.S. SYSTEM HAS BEEN HIDDEN BY THE ACCESS TO BORROWED MONEY.

for independence to reach sub-Saharan Africa and the remnants of colonial rule east of the Suez, the United Kingdom's age of hegemony was effectively over less than a dozen years after its victories over Germany and Japan.

The most recent and familiar example of precipitous decline is, of course, the collapse of the Soviet Union. With the benefit of hindsight, historians have traced all kinds of rot within the Soviet system back to the Brezhnev era and beyond. Perhaps, as the historian and political scientist Stephen Kotkin has argued, it was only the high oil prices of the 1970s that "averted Armageddon." But this did not seem to be the case at the time. In March 1985, when Mikhail Gorbachev became general secretary of the Soviet Communist Party, the CIA estimated the Soviet economy to be approximately 60 percent the size of the U.S. economy. This estimate is now known to have been wrong, but the Soviet nuclear arsenal was genuinely larger than the U.S. stockpile. And governments in what was then called the Third World, from Vietnam to Nicaragua, had been tilting in the Soviets' favor for most of the previous 20 years. Yet less than five years after Gorbachev took power, the Soviet imperium in central and Eastern Europe had fallen apart, followed by the Soviet Union itself in 1991. If ever an empire fell off a cliff—rather than gently declining—it was the one founded by Lenin.

OVER THE EDGE

IF EMPIRES are complex systems that sooner or later succumb to sudden and catastrophic malfunctions, rather than cycling sedately from Arcadia to Apogee to Armageddon, what are the implications for the United States today? First, debating the stages of decline may be a waste of time—it is a precipitous and unexpected fall that should most concern policymakers and citizens. Second, most imperial falls are associated with fiscal crises. All the above cases were marked by sharp imbalances between revenues and expenditures, as well as difficulties with financing public debt. Alarm bells should therefore be ringing very loudly, indeed, as the United States contemplates a deficit for 2009 of more than $1.4 trillion—about 11.2 percent of GDP, the biggest deficit in 60 years—and another for 2010 that will not be

Michael
Schuman

Ragin' Contagion. After Greece, will concerns about nations' debt loads derail the global economic recovery?

MY FIRST LESSON IN THE POWER OF contagion happened in 1997, when I was based in Seoul. The Asian financial crisis had started midyear in Southeast Asia—first in Thailand, where it was labeled "bahtulism," after Thailand's currency, the baht, and then spreading to Malaysia and Indonesia. From Seoul, half a continent away, the crisis seemed to be very distant. Why would a problem in Thailand extend to wealthier South Korea?

By October, the crisis had done exactly that. South Korea got infected by financial contagion. It took all of us in Seoul a while to wake up to that reality. On the surface, contagion makes no sense. Just because country A falls into a debt crisis doesn't mean countries B, C or G should as well. But that's not how investors think in times of uncertainty. Instead, they look for other potential trouble spots, then try to get out of them.

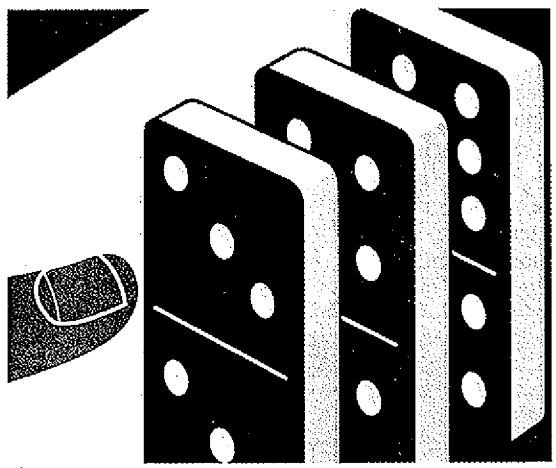
Bankers realized that, as in Thailand and Indonesia, the private sector in South Korea had unsustainable levels of debt, and they stampeded for the hills. Within weeks, South Korea was nearly emptied of hard currency and went begging for an International Monetary Fund (IMF) bailout.

Europe may be facing a similar contagion effect today. Worries that overindebted Greece could default sent investors scouring for the next ticking debt bomb. The euro zone has quite a selection to choose from: Portugal, Italy, Ireland and Spain, which, along with Greece, form the aptly nicknamed PIIGS.

What makes contagion so scary is that investors respond in a completely rational fashion: they panic. There's no way of knowing where contagion will stop

Yields on the sovereign bonds of Portugal and Spain have already risen, a sign that investors believe holding their debt is becoming riskier.

Not even the unprecedented $145 billion European Union–IMF bailout for Greece announced in early May is guaranteed to stop things from getting worse. In South Korea in 1997, the IMF rescue failed to restore shattered investor confidence. To do that took a further show of support for the country from the international community and a firm commitment to reform from the Seoul government.



For Greece, matters aren't all that different. Athens still must prove it can implement the brutal tax hikes, public-sector salary cuts and other budget-reduction measures it promised in return for the aid. With fierce domestic opposition to any austerity plan, investors remain doubtful Greece can uphold its end of the bargain. Nor will they take their wary eyes off the other PIIGS, which also need to undertake painful fiscal reforms to prevent their own Greek-style meltdowns.

And why stop in Europe? Much of the industrialized world is emerging from the Great Recession buried in debt, the result of historical profligacy mixed with the costs of stimulus packages and bank bailouts initiated during the recession. Japan, the U.K. and, let's not forget, the U.S. are each carrying ever larger loads of government debt.

I'm not predicting that the crisis in Greece will envelop the globe like a financial black plague. No investor should equate Greece's problems with those of the U.S. But we're not in normal times. Investors' psyches are plagued by a fragile global recovery and traumatized by memories of the post–Lehman Brothers collapse. There's no way of knowing where contagion will stop once it gets rolling.

Sound crazy? It's not. What makes contagion so scary is that investors respond in a completely rational fashion: they panic. During the Asian crisis, the thinking went like this: "I just lost a bundle on that Thailand thing, so I'm darn sure not going to get burned in South Korea. Better be safe than sorry and get out now." No one wants to be the sucker stuck with the losses more-panicky investors avoided. Once contagion sets in, investors perceive risk in ways that can make their fears become reality.

The way the euro zone has dealt with Greece's tragedy has shown a perplexing lack of understanding of this phenomenon. Instead of firmly backing Greece from the start, E.U. leaders like German Chancellor Angela Merkel waffled, hoping a few empty promises and anxious ministerial powwows would be sufficient to support investor confidence. They put domestic politics ahead of the stability of the euro zone and the entire global economy by letting the genie out of the bottle.

IN GREECE THE WEALTHY STOLE ALL THE MONEY. WHY SHOULD

Now, with the Greek rescue, Europe has finally shown the backbone to take on contagion. But it needs to do more. This is no longer a Greek crisis; it's a euro-zone crisis. The advantage Europe has today over Asia in 1997 is that it is more integrated. The Europeans ought to act collectively to stabilize and then reduce the debt loads of all the weaker euro-zone states. Or the Greek flu might spread beyond Europe. ■

ILLUSTRATION BY HARRY CAMPBELL FOR TIME

IT GOES FURTHER THAN THIS. GREECE NOW HAS NO SOVEREIGN CURRENCY WHICH COULD BE DEVALUED TO MAKE THE COUNTRY MORE COMPETITIVE.

$25 million, only $5.4 million has gone out to contractors.

There's a further difference between today's infrastructure work and that of the New Deal: It's much more productive, and hence employs fewer people. "The work itself has changed since the '30s—or the '60s," says Robert Balgenorth, president of the state AFL-CIO's Building and Construction Trades Council. An electrician, Balgenorth built high schools during the 1960s. "It took 15 to 20 electricians to build a high school then," he says. "It takes four or five today. Stuff that we had to assemble then comes pre-assembled today." Heavy equipment has changed as well. "You can haul more in bigger trucks today," he says. "You need fewer drivers."

And yet, some of these constraints were around in Roosevelt's day, too. The great projects of the PWA proceeded, at Ickes' insistence, with painstaking deliberation and constant fiscal oversight. Ickes required states and localities to come up with 55 percent of the funding for projects, which slowed things down even more. Hopkins made no such demands; in 1936, state and local governments covered just 9.8 percent of the WPA's costs.

Roosevelt had Hopkins create and run the CWA and then the WPA because he knew Hopkins would pay no heed to fiscal and procedural strictures. The work would be simple; the labor, cheap. The average monthly wage for WPA workers was $82; for PWA workers (more likely to be skilled craftsmen), it was $330. While the PWA was building the Oakland Bay Bridge, the WPA in Oakland was engaged in rat control, book repairs at libraries, park improvements, painting schools, and hacking away underbrush to create fire trails. There was no competitive bidding for these projects, no means test for workers, and not much in the way of skills requirements.

What we need is a think tank that tells us how to actually do a stimulus—how we can get the dollars out there now.

And therein lies the problem with Obama's stimulus package: To the extent that it follows in Roosevelt's footsteps, it doesn't really re-create the WPA at all. It re-creates the PWA—a far smaller program than the WPA in the number of people it employed and a far slower program to get up and running. Re-creating the WPA would require a sense of economic emergency so urgent that it would overcome not just the bureaucratic inertia common to much of government but also the conservative objections to more government spending, and the liberal objections to short-circuiting some of the safeguards erected against quick and large-scale infrastructure projects.

That doesn't mean liberals must go down the same road to countercyclical economics that China has, unhampered by the procedural, environmental, and democratic constraints that Americans take for granted. But these are not normal or healthy times, and liberals should exercise a preferential option for the tens of millions of unemployed Americans (particularly since their plight is not likely to be lifted through the normal workings of the economy), for reasons both of compassion and nation-building here at home.

Recently, Rep. George Miller of California, the chair of the House Education and Labor Committee, introduced a stimulus bill of his own, which would allocate roughly $100 billion to state governments, still facing massive cutbacks, to save the jobs of their teachers, nurses, cops, and firefighters. It's a necessary measure, but it doesn't address the continuing crisis in the manufacturing and construction sectors. Blue-collar men constitute 57 percent of the Americans who've lost jobs in this recession; blue-collar white men (who are 11 percent of the work force and 36 percent of the unemployed) are the group whose support for Obama and the Democrats, by the evidence of the polls, has fallen the furthest.

The way that the government can create the most jobs in the least time, however, is to create them in the home-care, child-care, and preschool industries. A February study from the Levy Economics Institute of Bard College found that a $50 billion investment in these industries would generate 1.2 million new jobs, while the same $50 billion applied to infrastructure would yield just 556,000 jobs. The case for such an investment is both economic and moral—the beneficiaries would disproportionately be low-wage women of color—but given the state of American politics today, the political obstacles to enacting such a program would be major. Only if it were linked to programs creating more construction jobs would it even be conceivable—and only barely at that.

What the nation needs economically, then, and what Obama needs politically, is a jobs bill that invests in home care and child care, boosts tax credits for domestic manufacturing (this is, in fact, the subject of one White House proposal), and hurls money into infrastructure spending (the kind of spending that Republicans oppose least). Obama then needs his own Harry Hopkins. The new Hopkins won't be able to dispense funds as quickly as the original, but he must convey the urgency and zeal for cutting red tape that Hopkins brought to the New Deal's job programs.

BUT IF THESE JOBS ARE CREATED NOW WITH STIMULUS MONEY, WHO WILL PAY WHEN THE STIMULUS MONEY RUNS OUT?

The heaviest lift, however, remains Obama's. The globalization (and the attendant overcapacity) of production and the long-term effects of the financial crisis mean that the manufacturing and construction sectors, which have provided decent-paying jobs to millions of workers and economic vibrancy to the nation, aren't likely to recover on their own. Obama needs to talk to Americans about the constrained economic future they will face if those sectors don't revive, as well as the benefits of more early childhood education and senior care—and why the nation needs a massive government commitment to those sectors to recapture its economic vibrancy.

With the enactment of health-care reform, Democrats now insist they have turned their focus to jobs, jobs, jobs. Saying so but not doing so will only bring down the wrath of the electoral gods. However arduous the task, they need to find their way to build a new WPA. TAP

WEATHERIZATION IS THE BEST USE OF STIMULUS MONEY BECAUSE IT SAVES BIG TIME IMMEDIATELY AND LONG-TERM.

FINANCES.

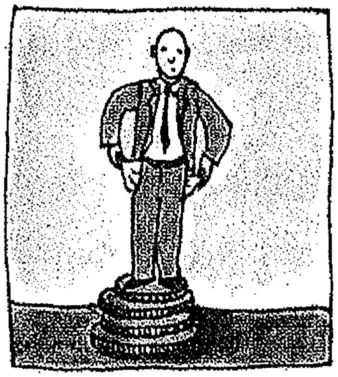
died in October 2008; Hamdan said he died of a heart attack upon hearing of his son's detention. Recently his brother Sam received a notice addressed to Naji that his aircraft mechanic's license was being rescinded by the Transportation Security Administration. Hamdan still suffers pains in his wrists, neck and shoulders from the beatings, and he is taking medication for his liver and kidneys. But it is the mental scars t tubbornly refuse to heal.

"So wake up in the middle of the night, just thinki ," he said. "What bothers me the most is the unfairi l.... I got beaten, tortured and forced to sign someth 't even read. I left all my wealth over there in that country, and I'm here, empty-handed, with these memories that are eating me alive." ■

In Defense of Deficits

A big deficit-reduction program would destroy the economy two years into the Great Crisis.

by JAMES K. GALBRAITH



CAITLIN DOVER

The Simpson-Bowles Commission, just established by the president, will no doubt deliver an attack on Social Security and Medicare dressed up in the sanctimonious rhetoric of deficit reduction. (Back in his salad days, former Senator Alan Simpson was a regular schemer to cut Social Security.) The Obama spending freeze is another symbolic sacrifice to the deficit gods. Most observers believe neither will amount to much, and one can hope that they are right. But what would be the economic consequences if they did? The answer is that a big deficit-reduction program would destroy the economy, or what remains of it, two years into the Great Crisis.

For this reason, the deficit phobia of Wall Street, the press, some economists and practically all politicians is one of the deepest dangers that we face. It's not just the old and the sick who are threatened; we all are. To cut current deficits without first rebuilding the economic engine of the private credit system is a sure path to stagnation, to a double-dip recession—even to a second Great Depression. To focus obsessively on cutting future deficits is also a path that will obstruct, not assist, what we need to do to re-establish strong growth and high employment.

I HAPPEN TO AGREE

BUT PEOPLE HAVE NO MORE COLLATERAL

To put things crudely, there are two ways to get the increase in total spending that we call "economic growth." One way is for government to spend. The other is for banks to lend. Leaving aside short-term adjustments like increased net exports or financial innovation, that's basically all there is. Governments and banks are the two entities with the power to create something from nothing. If total spending power is to grow, one or the other of these two great financial motors—public deficits or private loans—has to be in action.

For ordinary people, public budget deficits, despite their bad reputation, are much better than private loans. Deficits put money in private pockets. Private households get more cash. They own that cash free and clear, and they can spend it as they like. If they wish, they can also convert it into interest-earning government bonds or they can repay their debts. This is called an increase in "net financial wealth." Ordinary people benefit, but there is nothing in it for banks.

And this, in the simplest terms, explains the deficit phobia of Wall Street, the corporate media and the right-wing economists. Bankers don't like budget deficits because they compete with bank loans as a source of growth. When a bank makes a loan, cash balances in private hands also go up. But now the cash is not owned free and clear. There is a contractual obligation to pay interest and to repay principal. If the enterprise defaults, there may be an asset left over—a house or factory or company—that will then become the property of the bank. It's easy to see why bankers love private credit but hate public deficits.

BLACKSTONE CO.

All of this should be painfully obvious, but it is deeply obscure. It is obscure because legions of Wall Streeters—led notably in our time by Peter Peterson and his front man, former comptroller general David Walker, and including the Robert Rubin wing of the Democratic Party and numerous "bipartisan" enterprises like the Concord Coalition and the Committee for a Responsible Federal Budget—have labored mightily to confuse the issues. These spirits never uttered a single word of warning about the financial crisis, which originated on Wall Street under the noses of their bag men. But they constantly warn, quite falsely, that the government is a "super subprime" "Ponzi scheme," which it is not.

We also hear, from the same people, about the impending "bankruptcy" of Social Security, Medicare—even the United States itself. Or of the burden that public debts will "impose on our grandchildren." Or about "unfunded liabilities" supposedly facing us all. All of this forms part of one of the great misinformation campaigns of all time.

ALL TRUE

The ~~Dis~~information is rooted in what many consider to be plain common sense. It may seem like homely wisdom, especially, to say that "just like the family, the government can't live beyond its means." But it's not. In these matters the public and

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WHAT THE HELL ??

private sectors differ on a very basic point. Your family needs income in order to pay its debts. Your government does not.

Private borrowers can and do default. They go bankrupt (a protection civilized societies afford them instead of debtors' prisons). Or if they have a mortgage, in most states they can simply walk away from their house if they can no longer continue to make payments on it.

With government, the risk of nonpayment does not exist. Government spends money (and pays interest) simply by typing numbers into a computer. Unlike private debtors, government does not need to have cash on hand. As the inspired amateur economist Warren Mosler likes to say, the person who writes Social Security checks at the Treasury does not have the phone number of the tax collector at the IRS. If you choose to pay taxes in cash, the government will give you a receipt—and shred the bills. Since it is the source of money, government can't run out.

It's true that government can spend imprudently. Too much spending, net of taxes, may lead to inflation, often via currency depreciation—though with the world in recession, that's not an immediate risk. Wasteful spending—on unnecessary military adventures, say—burns real resources. But no government can ever be forced to default on debts in a currency it controls. Public defaults happen only when governments don't control the currency in which they owe debts—as Argentina owed dollars or as Greece now (it hasn't defaulted yet) owes euros. But for true sovereigns, bankruptcy is an irrelevant concept. When Obama says, even offhand, that the United States is "out of money," he's talking nonsense—dangerous nonsense. One wonders if he believes it.

TELL THAT TO ICELAND. -- OR GREECE.

Nor is public debt a burden on future generations. It does not have to be repaid, and in practice it will never be repaid. Personal debts are generally settled during the lifetime of the debtor or at death, because one person cannot easily encumber another. But public debt does not ever have to be repaid. Governments do not die—except in war or revolution, and when that happens, their debts are generally moot anyway.

So the public debt simply increases from one year to the next. In the entire history of the United States it has done so, with budget deficits and increased public debt on all but about six very short occasions—with each surplus followed by a recession. Far from being a burden, these debts are the foundation of economic growth. Bonds owed by the government yield net income to the private sector, unlike all purely private debts, which merely transfer income from one part of the private sector to another.

Nor is that interest a solvency threat. A recent projection from the Center on Budget and Policy Priorities, based on Congressional Budget Office assumptions, has public-debt interest payments rising to 15 percent of GDP by 2050, with total debt to GDP at 300 percent. But that can't happen. If the interest were paid to people who then spent it on goods and services and job creation, it would be just like other public spending. Interest payments so enormous would affect the economy much like the mobilization for World War II. Long before you even got close to those scary ratios, you'd get full employment and rising inflation—pushing up GDP and, in turn, stabilizing the debt-to-GDP ratio. Or the Federal Reserve would stabilize the interest payouts, simply by keeping short-term interest rates (which it controls) very low.

What about indebtedness to foreigners? True, foreigners do us a favor by buying our bonds. To acquire them, China must export goods to us, not offset by equivalent imports. That is a cost to China. It's a cost Beijing is prepared to pay, for its own reasons: export industries promote learning, technology transfer and product quality improvement, and they provide jobs to migrants from the countryside. But that's China's business.

For China, the bonds themselves are a sterile hoard. There is almost nothing that Beijing can do with them. China already imports all the commodities and machinery and aircraft it can use—if it wanted more, it would buy them now. So unless China changes its export policy, its stock of T bonds will just go on growing. And we will pay interest on it, not with real effort but by typing numbers into computers. There is no burden associated with this, not now and not later. (If the Chinese hoard the interest, they also don't help much with job creation here. So the fact that we're buying a lot of goods from China simply means

As government programs, Social Security and Medicare cannot go bankrupt—unless Congress cuts the benefits they provide.

we have to be more imaginative, and bolder, if we want to create all the jobs we need.) Finally, could China dump its dollars? In principle it could, substituting Greek bonds for American and overpriced euros for cheap dollars. On brief reflection, no Beijing bureaucrat is likely to think this a smart move.

GALBRAITH OMITS THE PRIMARY OUTCOME OF CHINA'S SURPLUS OF DOLLARS; CHINA IS BUYING U.S. CORPORATIONS EITHER BY STOCK PURCHASE OR OUTRIGHT.

What is true of government as a whole is also true of particular programs. Social Security and Medicare are government programs; they cannot go bankrupt, and they cannot fail to meet their obligations unless Congress decides—say on the recommendation of the Simpson-Bowles Commission—to cut the benefits they provide. The exercise of linking future benefits and projected payroll tax revenues is an accounting farce, done for political reasons. That farce was started by FDR as a way of protecting Social Security from cuts. But it has become a way of creating needless anxiety about these programs and of precluding sensible reforms, like expanding Medicare to those 55 and older, or even to the whole population.

Social Security and Medicare are transfer programs. What they do, mainly, is move resources around within our society at a given time. The principal transfer is not from the young to the old, since even without Social Security the old would still be around and someone would have to support them. Rather, Social Security pools resources, so that the work of the young collectively supports the senior population. The effective transfer is from parents who have children who would otherwise support them (a fairly rare thing), to seniors who don't. And it is from workers who do not have parents to support, to workers who would otherwise have to support their parents. In both cases this burden sharing is fair, progressive and sustainable. There is a healthcare cost problem, as everyone knows, but that's not a Medicare problem. It should not be solved by cutting back on healthcare for the old. Social Security and Medicare also replace private insurance with cheap and efficient public administration. This is another reason these programs are the hated targets, decade after decade, of the worst predators on Wall Street.

Public deficits and private lending are reciprocal. Increased private lending generates new tax revenue and smaller deficits; that's what happened in the 1990s. A credit collapse kills the tax base and generates more spending; that's what's happening now, and our big deficits are the accounting counterpart of the massive decline, last year, in private bank loans. The only choice is what kind of deficit to run—useful deficits that rebuild the country, as in the New Deal, or useless ones, with millions kept unnecessarily on unemployment insurance when they could instead be given jobs.

If we could revive private lending, should we do it? Well, yes, up to a point there is good reason to have a robust private lending sector. Government is by nature centralized and policy driven. It works by law and regulation. Decentralized and competitive private banks have much more flexibility. A good banking system, run by capable people with good business judgment who know their clients, is good for the economy. The fact that you have to pay interest on a loan is also an important motivator of investment over consumption.

But right now, we don't have functional big banks. We have a cartel run by an incompetent plutocracy, with its long fingers deep in the pockets of the state. For functional credit to return, we'll have to reduce the unpayable private debts now outstanding, to restore private incomes (meaning: create jobs) and collateral (meaning: home values), and we'll have to restructure the big banks. We need to break them up, shrink the financial sector overall, expose and prosecute frauds, and create incentives for profitable lending in energy conservation, infrastructure and other sectors. Or we could create a new parallel banking system, as was done in the New Deal with the Reconstruction Finance Corporation and its spinoffs, including the Home Owners' Loan Corporation and later Fannie Mae and Freddie Mac.

Either way, until we have effective financial reform, public budget deficits are the only way toward economic growth. You don't have to like budget deficits to realize that we must have them, on whatever scale necessary to restore growth and jobs. And we will need them not just now but for a long while, until we've shaped a strategic program for investment, energy and the environment, financed in part by a reformed, restored and disciplined financial sector.

It's possible, of course, that all the deficit hysteria is intended to divert attention from the dysfunctions of private banking, and so to help thwart calls for financial reform. Is that giving them too much credit? Maybe. Maybe not. ■

Letters

(continued from page 2)

People's History of the United States. We need to create a real democracy rather than "take back" an imaginary one. We need a constitutional amendment to overhaul the electoral process and ensure its integrity. As Lawrence Lessig states, Congress is no more likely to propose a constitutional amendment than to enact electoral reform. It falls to us, the citizens, to create an amendment and build the grassroots movement to force its adoption.

Philip Anderson, Valerie Kozlovsky

Victor, N.Y.

Lawrence Lessig's analysis of our failing democracy needs to be Vulcan mind-melded into the brains of all Americans. Unless we join together to oppose the takeover of government by big money, we lose. As someone who has been advocating public funding of elections for four years, there is one tweak I must make to Lessig's strategy. We must turn back *Citizens United v. FEC* (most likely by constitutional amendment) *before* we enact public funding of elections. The order is very important. In states like Arizona where public funding is already law, special interest candidates can run using public money. Then their corporate godfathers tip the scales with devastating media buys during those sixty critical days before the election. Alas, with a single bang of the nation's weightiest gavel, the Supremes turned strong progressive electoral law into exactly what the right has tried to frame it to be—welfare for politicians.

Sam A. Fedele

Fairfax, Va.

If the only way to fix our government is a constitutional amendment, we're in for an extended period of national grief. A faster (though less permanent) way of confronting the *Citizens United* decision might be through executive order. Is this a stretch? Perhaps, but we shouldn't forget that it was by executive order that President Bush designated Afghanistan as a combat zone and declared that the CIA's interrogation techniques fell outside the Geneva Conventions.

Thomas I. Siemsen

West Orange, N.J.

Lessig's constitutional convention is a good approach. I propose that members of Congress be continuously measured against the will of the people. To do this, citizens must have the ability to "vote" on the bills online. Such a system would have to be centralized, neutral and truly reflect the will of the people. Votetocracy.com attempts to achieve just that.

David Kraljic

Arlington, Va.

Lawrence Lessig suggests convening a constitutional convention but notes that getting approval of two-thirds of the states might not be easy. There is another alternative. Constitutional law professors Akhil Reed Amar at Yale and Alan Hirsch at Williams judge that "Article V merely sets forth one mode of amendment.... There also exists a separate means of amending the Constitution: a national referendum (of sorts) by We, the People."

Allan Matthews

Los Angeles

The fundamental problem is that we can't have political democracy without economic democracy. Steps to achieving both are under way in South America and Europe. In our corporate state this is a harder challenge but one I believe we must face.

Nina Byers

SEIGNIORAGE: THE PROFIT WHICH A GOVERNMENT MAKES ON THE COINAGE OF MONEY. AT ONE TIME PRINCES AND KINGS MADE NICE PROFITS FROM MONEY COINAGE. PRACTICALLY ALL MODERN GOVERNMENTS FOREGO THIS.

Sēn'yər ij

the part of any Fed chairman since t[illegible]ion's founding, seems convinced that fine adju[illegible]o these two controls will allow him to manage th[illegible]el perfectly.

WHY WOULD THE FED DO THIS ?

FIAT MONEY: PAPER CURRENCY MADE LEGAL TENDER BY LAW OR FIAT, ALTHOUGH NOT BACKED BY GOLD OR SILVER AND NOT NECESSARILY REDEEMABLE IN COINS.

Buried within the bailout bill of[illegible]3, 2008, that set up the Troubled Asset Relief Program (TARP) was a provision permitting the Fed to pay interest on bank reserves. This seemingly technical change not only gives banks an incentive to hold reserves rather than make loans; it also essentially converts reserves into more government debt. Fiat money traditionally pays no interest and therefore allows the government to purchase real resources without incurring any future tax liability. Economists refer to this revenue from creating money as *seigniorage.* Federal Reserve notes will continue to earn no interest. But now the seigniorage that government gains from creating bank reserves will be much reduced, if not entirely eliminated.

Outside of America's two hyperinflations (during the American Revolution and under the Confederacy during the Civil War), seigniorage peaked during World War II, to nearly a quarter of the war's cost, or about 12 percent of GDP. By the Great Inflation of the 1970s, financial innovations and market sophistication had managed to reduce seigniorage to only 2 percent of federal revenue, which translates into less than half a percent of GDP. Now with the Fed having to divert potential government revenue to pay interest on base money held by banks, seigniorage has virtually been eliminated as a source of future funding. And this constraint will become tighter as people replace the use of currency with bank debit cards and other forms of electronic fund transfers.

This is not to say that monetary increases cannot still generate high inflation rates. But if the U.S. does get high inflation, even inflation exceeding double digits, the government is still confined to essentially two sources of revenue: 1) current taxes and 2) borrowing, which represents future taxes.

Interest-earning bank reserves also blur the distinction between monetary policy and fiscal policy. To see how, imagine the extreme case: Assume the interest the Fed pays on reserves is exactly the same as the interest the Treasury pays on its outstanding debt. Then Fed open-market operations are no longer exchanging government debt for created money; they are exchanging one form of government debt for another form. Monetary policy becomes entirely neutral and impotent, in a self-fulfilling Keynesian prophecy. ■

Jeffrey Rogers Hummel is an associate professor of economics at San Jose State University.

Inflation? We Should Be So Lucky

Scott Sumner

This crisis has been poorly understood by economists fro[m] the very beginning. The original subprime crisis of 200[…] had a relatively modest impact on both financial marke[ts] and the broader economy. The much more severe crash [of] late 2008 resulted from monetary policy (unintentional[ly] becoming far too contractionary for the economy's need[s]. Most economists missed this problem, as they are used [to] looking at faulty indicators such as nominal interest rat[es] and the monetary base (which is the money actually pr[o]duced by the Fed—cash plus bank reserves). Milton Frie[d]man and Anna Schwartz showed that these two indicato[rs] gave highly misleading signals during the Great Contra[c]tion of 1929-33. They are no more reliable in the curre[nt] crisis.

It is discouraging to see so many free market economi[sts] now warning of an inflationary time bomb. I'm afraid th[e] *New York Times* columnist and recent Nobel Prize winn[er] Paul Krugman is right: The real problem is that inflation [is] likely to remain too low.

In a fiat money world the only sensible indicator [of] monetary policy is market expectations of growth in t[he] variable actually being targeted by the central bank. Th[e] variable might be the Consumer Price Index, but I beli[eve] the economy would be more stable if the Fed targeted no[mi]nal GDP at a roughly 5 percent annual growth rate. We kn[ow] from various asset markets that nominal growth expec[ta]tions turned quite bearish after mid-2008. This sever[ely] depressed aggregate demand and dramatically worse[ned] the debt crisis.

Almost everyone has reversed the causation, assum[ing] that the intensification of the financial crisis caused the drop in nominal income, whereas the reverse is closer to truth. Nine months later the markets continue to signal t[hat] inflation and nominal growth will remain below the F[ed's] implicit target for years to come. Monetary policy rem[ains] too contractionary, which has led to a very costly relia[nce] on fiscal stimulus.

Most economists have a deeply ingrained instinct [that] printing money inevitably leads to inflation. Although [our] gut might tell us that the recent explosion of the mone[tary] base is reminiscent of Germany circa 1923, it is actu[ally] more like Japan after 1998. Yet Japan has seen almos[t no] growth in nominal incomes since 1993. This isn't to [say] that Japan was "stuck" in a liquidity trap; although nom[inal] interest rates cannot fall below zero, monetary policy c[…]

Eva L[…]
Tallah[…]

FIAT MONEY: PAPER MONEY CALLED "FIAT" BECAUSE ITS USE AS MONEY DEPENDS UPON THE CREDIT OF THE GOVERNMENT ISSUING IT AND NOT UPON ANY RIGHT TO CONVERT PAPER INTO METALLIC CURRENCY.

EDITOR'S LETTER

The Big Steal

NIGEL PARRY

Have you noticed that banks have essentially gone out of the banking business? By that I mean taking in deposits and then lending the money back out with a small interest-rate markup. If you're the owner of a small to mid-size business, or a solvent homeowner trying to refinance your mortgage to take advantage of historically low interest rates, you will know what I mean. There are two main definitions for "bank" listed in *Merriam-Webster*. The first one defines it as "an establishment for the custody, loan, exchange, or issue of money, for the extension of credit, and for facilitating the transmission of funds." That sounds pretty much like what most of us consider a bank—or, at least, used to. The second definition is "a person conducting a gambling house or game." And that sounds pretty much like what most big bankers now consider a bank. Major financial institutions such as Goldman Sachs and Morgan Stanley increasingly make their vast profits (and bonuses) by acting as betting houses, placing side wagers on myriad financial instruments that even they admit are too complex to understand. The almost two dozen big banks rescued by the Treasury in 2008 have consistently cut their business lending every month since April 2009, when they were ordered to file regular reports. And the smaller banks—the ones that used to lend just about any amount of money to just about anyone during the subprime-mortgage bubble—now lend just about nothing to no one.

After being bailed out by the taxpayers when its side wagers on the subprime-mortgage run-up went horribly bad, Wall Street rebounded just a little too quickly in the eyes of many, while other segments of the population—pretty much anyone who isn't a banker—continue to suffer, and will likely do so for many years ahead. If the side bets the big banks place are all aboveboard, as their C.E.O.'s claim, why object to making a transparent, public market for them for everyone to see?

The testimony by current and former bank officers before the Financial Crisis Inquiry Commission has done little to dampen the public appetite for some Wall Street blood. Robert Rubin, the 26-year veteran of Goldman Sachs and former Treasury secretary who became chairman of Citigroup's executive committee in 1999, testified before the commission that he had no real operational authority over the bank and therefore bore no responsibility for its colossal subprime-mortgage mess, which required a $45 billion bailout. Rubin's testimony was a remarkable performance, given that he had collected $126 million in cash and stock over the past decade for what he now says was essentially a non-job job. Would that we all could land such a cushy position. Charles Prince III, former C.E.O. of Citigroup, ducked responsibility by saying, "I'm sorry that our management team, starting with me, like so many others, could not see the unprecedented market collapse that lay before us." Translation: *Who knew that if you played with matches something could catch fire?*

You would think that the big banks would have realized that the jig is up and that they will almost certainly have to go along with the financial reform Washington will be sending their way. Instead, they continued to fight a well-financed rearguard action. Goldman Sachs alone had 46 lobbyists from more than a dozen firms working the corridors to kill proposed legislation. Not surprisingly, they've found any number of willing soulmates among Washington Republicans—the "gag reflex" of financial reform, as Peter Sagal, the host of NPR's *Wait Wait . . . Don't Tell Me!*, puts it. As the Senate Banking Committee was debating the finance-reform bill, Goldman Sachs employees wrote checks totaling more than $34,000 to the committee's ranking Republican member and chief obstructionist, Senator Richard Shelby. It's amazing how little it takes to buy off a politician these days.

The Securities and Exchange Commission's fraud charges against mighty Goldman Sachs—reminiscent of the successful criminal insider-trading case against Drexel Burnham Lambert in the 1980s—have sent chills through the canyons of Wall Street. Indeed, if ever there was a *There but for the grace of God* moment in the big-time banking community, this was it. The relief was short-lived, however, as word trickled out that a number of other big financial houses are also in the S.E.C.'s sights. For its part, Goldman Sachs says it will vigorously defend itself against the accusations. Nevertheless, the charges may result in a flood of investor suits against not only Goldman but also the other banking interests that drank the subprime Kool-Aid. There is, too, the growing sentiment that on Wall Street, as on the Vegas Strip, the house always wins, and the suckers—in the banks' case, the small investors—go home broke.

I keep coming back to the Senate Committee on Banking and Currency, which was established to investigate the root causes of the 1929 Wall Street crash that brought on the Great Depression. It became known as the Pecora Commission, named for the banty, Italian-born former prosecutor Ferdinand Pecora, whose bravura performance in parrying with the nation's most influential bankers became the stuff of popular lore. When J. P. Morgan Jr. was questioned, he said in his opening statement, "Without hesitation . . . I consider the private banker a national asset and not a national danger." Pecora then asked, "What is your business or profession?" When Morgan answered, "Private banker," the gallery roared with laughter.

As historian Alan Brinkley illustrates in "When Washington Took On Wall Street," on page 156, Morgan's "humiliation was only just beginning." Pecora deftly exposed the bankers' sleights of hand and outright crimes and in the process gave the American idiom a new word: "banksters"—a play on "bankers" and Depression-era "gangsters." The Pecora Commission also gave impetus to a spate of Wall Street reforms, including the creation of the S.E.C. and the Federal Deposit Insurance Corporation and the passage of the Glass-Steagall Act, which was designed to stem the sort of recklessness that got us into this recent mess. These measures helped keep the financial industry on the straight and narrow (and generally solvent) for generations.

But Pecora knew all too well that the forces underlying financial speculation, particularly greed and chicanery, never really disappear. At best you try to keep them in check for a while. "It cannot be doubted," he wrote in 1939, "that, given a suitable opportunity, they would spring back into pernicious activity." Pecora was, unfortunately, absolutely correct. Beginning in the early 1980s, many of the reforms put into place after his hearings were relentlessly undermined. It's hard to believe, in light of our current political culture, but the Pecora Commission was set up not by Democrats but by Senate Republicans. This time around, Senate Republicans, led by financial lobbyist . . . sorry, *Senate minority leader* Mitch McConnell—who has pocketed more than $1 million in campaign donations from Wall Street interests—have become virtual shills for the financial institutions that so hobbled the nation's and the world's economies. —GRAYDON CARTER crunch and beat Wall Street at their own game by keeping our money right here in Michigan and investing it to retool our economy and create jobs," says the populist mayor of Lansing. In Illinois, Green Party gubernatorial nominee Rich Whitney, who won 10 percent of the statewide vote in 2006, proposes depositing all state tax revenues and pension contributions in a state bank. "Instead of using state funds as a means to further enrich private banks, a state-owned bank could earn additional revenue for the state while at the same time help spur economic development in Illinois," he argues.

It is not just candidates who are talking up bold remedies to the challenges created and perpetuated by "too big to fail" banks. Legislators from Vermont to Virginia, from Michigan to Washington State, are proposing to start state banks. They take inspiration from the Bank of North Dakota, created ninety-one years ago by radical Non-Partisan Leaguers to serve as the depository for all state tax collections and fees. The nation's only state-owned bank avoided subprime lending and the derivatives markets during the recent real estate bubble and now has $4 billion under management. It maintains the faith of its founders and, in the words of bank president Eric Hardmeyer, continues to "plow those deposits back into the state of North Dakota in the form of loans. We invest back into the state in economic development type of activities." What that means, according to Ellen Brown, author of the book *Web of Debt*, is that North Dakota has avoided the credit freeze "by creating its own credit [and] leading the nation in establishing state economic sovereignty."

That sounds good to Massachusetts Senate president Therese Murray, who wants her state to look into creating its own bank. Washington House finance committee vice chair Bob Hasegawa, a Seattle Democrat, has formally proposed a State Bank of Washington. "Imagine financing student aid, infrastructure, industry and community development. Imagine providing access to capital for small businesses, or otherwise leveraging our resources instead of having to do it with tax incentives," he says. "Imagine keeping our resources local instead of exporting them as profits, never to be seen again—that's what this bank could do."

The movement to create state-run banks is part of a broader push to put public money to work for the people. In Los Angeles the City Council voted unanimously on March 5 to ensure that taxpayer money is invested only in banks that have established track records of helping families stay in their homes, lending to small businesses that create jobs and eschewing toxic interest-rate "swaps" that saddle communities with excessive fees and interest rates. Pennsylvania's auditor general, Jack Wagner, is leading a campaign in that state to get local governments and school boards to stop risking public funds with investment banks that engage in deals Wagner describes as "tantamount to gambling with public money." Urging these initiatives on is the Service Employees International Union, which is waging a national campaign to stop investing in unaccountable banks. "It's time for Wall Street banks to stop focusing on their profits and start doing their part to help our cities and families recover," says SEIU secretary-treasurer Anna Burger.

The prospect of what might be done with all the money that has flowed from the federal Treasury to private bank has some players talking of taking the North Dakota mode national. At a *Nation* magazine "Meltdown" event a year ago Stiglitz suggested, "If we had used the $700 billion to creat a new financial institution, allowed it to lever 10 to 1, which i very modest compared to the 30 to 1 that we were doing—1 to 1 would have generated $7 trillion of new lending capacity far in excess of what our country needs. So the issue here is nc about lending. It's really about saving the bankers. And wha we confused was saving the banks versus saving the bankers an their shareholders." Yet as Washington struggles with the tas of imposing basic regulation on big banks, the action will be i the states. How likely is that? Hardmeyer used to doubt that th North Dakota model would ever be adopted elsewhere. Now he says, "when I look around the country, it's not quite as far leap as I once thought it was."

JOHN NICHOI

Calvin Trillin, Deadline Poet

Future Governor Races in New York; A Voter Speaks

Our sights have been lowered.
Our backing is firm
For anyone likely
To serve out his term.

Chile Shaking

COMMENT

The most treacherous aftershock of Chile devastating earthquake was the yawning divide between ri and poor—a fissure that has been mostly papered over by se eral decades of denial and delusion. One needed look no furth than the Twitter torrent gushing from the broken country with hours of the temblor. As swarms of desperate Chileans sack and emptied the shelves of every market a pharmacy in the hardest-hit, isolated sou ern region, there was a virtual tsunami tweets, laden with class- and race-charged epithets, demandi that the army shoot to kill all "delinquents," along with a flu of nostalgic pleas for a return to military dictatorship.

Indeed, with the veneer of social order crumbling alm as fast as the half-million to 1.5 million homes of wood, ad and other substandard materials, outgoing President Mich Bachelet ordered tank regiments and thousands of combat tro into the affected areas, producing chilling scenes, reminiscen the Pinochet era, of nervous conscripts pointing their rifles at backs of detained "vandals." At one point an eighteen-hour-a- curfew was clamped down on the battered city of Concepciór if its population were suspects rather than victims.

Making Bank

Are simple savings plans the first step to combating poverty?

BY TIM FERNHOLZ

The New York City Department of Consumer Affairs is housed on some rented floors near Wall Street, amid great banks that profited as millions of American consumers bought toxic loans and catalyzed a recession that drove further millions out of work. While the department doesn't have jurisdiction over the big banks, it is often charged with cleaning up the messes they create. The office, which is painted in a decidedly un-bureaucratic neon-orange and royal-blue color scheme, features exhibits about the 40th anniversary of the Department of Consumer Affairs including a display of the brass weights once used by city officials to check merchants' scales and prevent fraud. Until recently, the department's core mission hadn't changed much: Ensure that weights and measures are accurate and that truth-in-pricing laws are enforced.

When Mayor Michael Bloomberg was elected to a second term in 2006, he commissioned a group of New Yorkers, led by Geoffrey Canada of the Harlem Children's Zone and Time Warner Chair and CEO Richard Parsons, to figure out innovative ways to fight poverty. One of the group's ideas concerned the relatively modish anti-poverty strategy of asset-building—removing the structural obstacles that prevent people from building financial stability. "People in communities in which poverty is concentrated suffer not from an absence of ambition but from a chronic lack of access to capital," the committee's report observed. "The City should continue to educate the public on low-income banking and other services and create new programs to promote comparison shopping, savings and asset building."

And so the city did just that, creating an Office of Financial Empowerment to develop pilot programs to meet those goals. They chose to house the OFE inside the Department of Consumer Affairs, rather than somewhere in the city's vast social-services bureaucracy, even though regulators are normally analogized to watchdogs or cops on the beat, not thought of as being responsible for administering social policy. "We are not running that safety net, but that safety net needs to be in place," explains Veronica White, who directs the task force that designed the OFE program. Instead, she says, OFE's mission is to give people the tools they need to get out of poverty.

"The lens of financial empowerment has remade this agency," says Department of Consumer Affairs Commissioner Jonathan Mintz, a quiet, genial man who previously worked as a lawyer, a law professor, and a second-grade teacher. The OFE gives his department "the ability to focus our enforcement, to think about zeroing in on neighborhoods" with high rates of people who lack access to financial services and heavy concentrations of fringe financial businesses such as check-cashers and pawn shops. Over 800,000 adult New Yorkers lack any bank account (the "unbanked"), and many more are "semi-banked"—they may have bank accounts but also use check-cashers and their ilk at greater cost.

The Office of Financial Empowerment seeks to educate people about their finances, find ways to encourage wealth-building behavior, and provide services, from tax preparation to financial products, that bring the first two goals into being. The most innovative product from the OFE is the SafeStart Bank Account. It's what finance people refer to as a "plain vanilla" product, a simple savings account with a starting balance of $25, no overdraft or monthly fees, and an ATM card.

SafeStart accounts offer a fresh start for people who haven't had a bank account before—or can't get one thanks to bad experiences in the financial sector. Combined with financial counseling and other resources in the OFE, these accounts represent one of the most forward-thinking and effective public-policy responses to the financial challenges of the working poor. The program began with a pilot limited to participants in a now-defunct anti-poverty effort called Opportunity NYC that gave cash incentives to low-income people who took steps to pull themselves and their families out of poverty. At first, 55 percent of Opportunity NYC participants were unbanked; two years later, only 7 percent are, with some 1,800 accounts opened. Now, the program is opening to the public and expanding citywide.

The reasons why certain people lack bank accounts are not Big Apple–specific: Our consumer-credit system is broken, with even brand-name banks adopting practices that range from usurious to predatory. In Washington, policy-makers are debating what to do about this consumer-credit crisis, which preceded the recession—in the form of the sub-prime mortgage bubble—and now exacerbates its worst effects. There is a broad consensus that more savings and safer loans are a key part of digging out of the recession. One of the most promising ideas is a federal Consumer Financial Protection Agency that would regulate financial products, kind of a New York Department of Consumer Affairs writ large. If we are to understand the potential of the CFPA, we must start with what's happening in New York.

"We've been working with the Treasury Department, advising them on a national banking initiative that they have proposed in the budget," Mintz says. "If New York City can leverage a bank account, imagine what the Treasury Department can do."

MELROSE, BRONX, IS A WORLD AWAY from Wall Street, nearly 40 minutes north on the subway. Where the financial district's bustle is contained within antiseptic lines of concrete and glass, here the skyline is lower and the storefronts colorful and haphazard; more people are on the street, buying and selling at sidewalk stands. A third of the neighborhood's residents are unbanked, and half are low-income. In the eight blocks between the subway and the OFE's local outpost, I count some six check-cashing stores and pawn shops. But there are just as many branches of regular retail banks scattered through the neighborhood.

The conventional wisdom about the unbanked is that they simply don't have access—that banks don't invest in neighborhoods where poor people live, and therefore poor people don't have bank accounts. But a recent study of consumer finance in Melrose and in Jamaica, Queens, conducted by the Department of Consumer Affairs, turned up some counterintuitive conclusions. In Melrose and Jamaica, as in other places, there was no correlation between the number of bank branches per capita and the number of people with bank accounts.

That leaves another hypothesis: It's not the access; it's the *products*. The savings and checking accounts offered by banks weren't meeting the needs of the residents of neighborhoods like Melrose and Jamaica. Low-income New Yorkers don't need online bill payment, they don't have direct deposit, and they are often the victims of overdraft fees that are poorly explained and nearly as usurious as the check-cashers' policies. What they need is clarity, speed, and reliability, which are all things the check-cashers provide, at a cost. The 110,000 residents of Melrose and Jamaica are estimated to spend some $19 million per year in check-cashing fees alone.

What the "unbanked" need are accounts that won't hurt them and financial education so they don't hurt themselves.

It may seem obvious, but overpaying for consumer credit is a critical obstacle to escaping poverty. That isn't the only downside of participating in the fringe financial system. At the most basic level, it's not as safe; keeping cash on hand invites crime and makes a mugging or a robbery a devastating financial experience. Without savings and a bank account, it's hard to build a credit score that would support a home or automobile loan that isn't predatory; it can even be difficult to access rental housing. It can also be harder to get a job now that employers have started checking applicants' credit scores as part of their interview processes. Even getting a cell phone is complicated with bad credit. This is a problem that affects low-income people generally and minorities in particular: Federal Deposit Insurance Corporation studies find that nearly 8 percent of Americans are unbanked, including nearly one-fifth of black and Hispanic households.

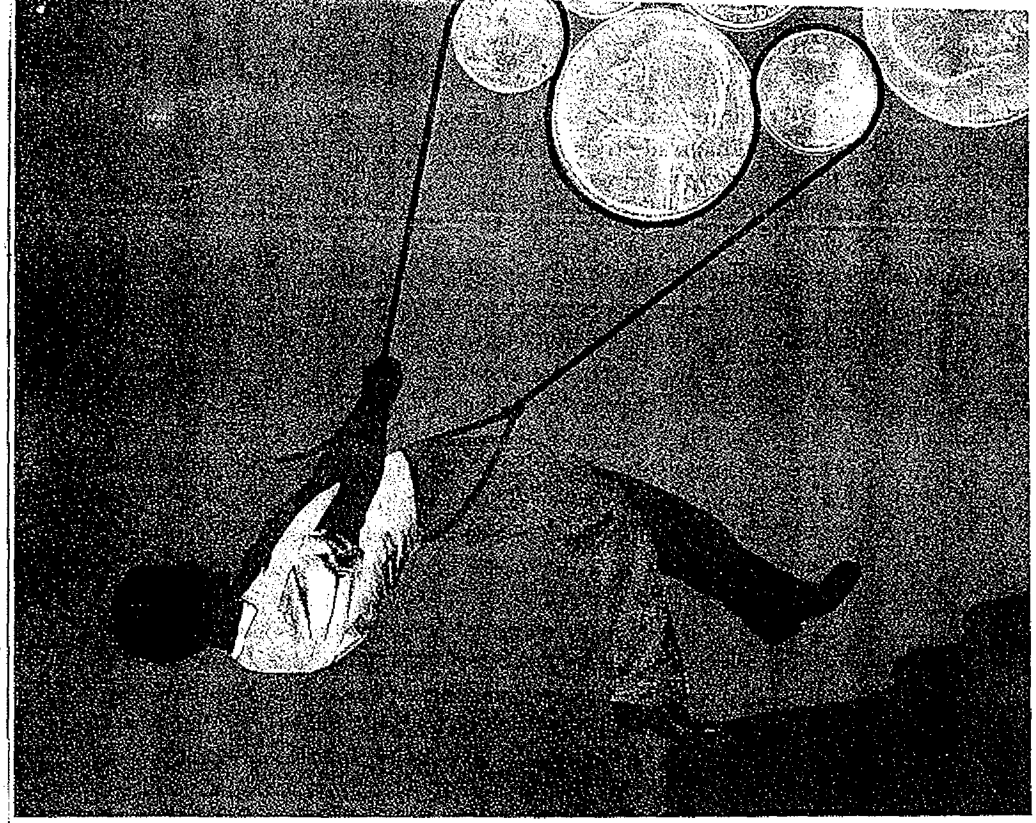
If the problem is product, how do you solve it? The private sector seems uninterested; check-cashers have managed to corner this market because commercial banks don't think it is profitable, and credit unions can't compete with marketing and ease of access that fringe financial firms offer. The Department of Consumer Affairs decided to leverage the government's brand and resources by creating and promoting accounts that would be both safe for consumers and attractive to the banks—and thus the SafeStart Bank Account was born. The department gathered nearly all the banks and credit unions operating in New York City and asked if they would sell the product in return for the city's promotional efforts. Ten agreed: five banks and five credit unions.

"Where the rubber hits the road for us, if we find that we're making money off these customers, that's the best sales pitch," says Steven Flax, a vice president at the participating M&T Bank. "The city sort of makes the case: These are the diamonds in the rough that we nurtured from theoretically unbankable to bankable."

Taking customers from unbanked to banked doesn't just mean creating accounts that won't hurt them; it also means providing financial education so they don't hurt themselves. The city, thanks to private funding, has set up financial-empowerment centers staffed with full-time counselors who make appointments with people who need help straightening out their books. One such center is located at the Lower East Side Peoples Federal Credit Union, an unassuming corner storefront in Alphabet City. Inside, it looks like George Bailey's bank from *It's A Wonderful Life*, but the tellers sit behind thick, bullet-proof Lexan glass.

That's where I meet Michelle Morillo, a social worker whose employer, a nonprofit called Credit Where Credit is Due, has been hired by the OFE to staff the bank's financial-empowerment center. Sitting at a metal desk located next to the old vault, Morillo, who sports neon-blue Ugg boots and a Long Island accent, offers crisp advice and tough love to her clients. "If they live paycheck to paycheck, unbanked, scared to get banked? Get over it," she says. She knows whereof she speaks: A single mother raising a 14-year-old son, she had her own trouble making payments on her student loans. There is, she realizes, a pervasive "fear of facing the situation. A lot of people don't want to know how much debt they owe."

I sit with Morillo while she meets with a client who we'll call Elizabeth, a 32-year-old recent divorcee who is living paycheck to paycheck and is several thousand dollars in debt as she starts a new business. Morillo quickly runs her through her "pieces"—the student loan piece, the debt piece, the medical bill piece, the budget piece. By the time they have gone over Elizabeth's finances, she has applied to consolidate her



vate donors. Ironically, some of the funds come from American International Group, a firm at the center of the financial blowup, and from Citibank, which has declined to participate alongside other banks.

"It's working out well, but it's only one day a week, and we have more than enough demand for people to be there full time," Salmon writes in an e-mail. "The main challenge for them, I think, is to get onto the city budget as their own line item."

The question remains: Is this is a New York City–only program, made possible by the Bloomberg administration's unique ability to deploy the mayor's philanthropic connections, or potentially a nationwide approach to fighting poverty? The Office of Financial Empowerment's 2010 budget included just over $2 million in public funds, but its more innovative programs are primarily supported by private money: The financial-empowerment centers require $1 million in donations. Without the counseling they provide, the SafeStart accounts would be a no-go.

debt, tightened up her monthly budget to make more room for savings, and drafted a legal challenge to a debt collector. Although Elizabeth already has a bank account, it's easy to see how this kind of personal attention would help put people who are unbanked back into the system.

"Looking at my friends, some people are taught, and other people aren't. I just realized my parents are terrible with their money to this day," Elizabeth says. Before meeting Morillo, she says, "I was just kinda getting by."

When I ask Morillo whether her clients found the city-branded bank accounts useful, she nods. "A lot of people go into debt because they didn't trust, and just knowing that the city is connected is an asset."

LIKE ANY EFFORT JUST GETTING OFF the ground, the financial-empowerment program doesn't always work. Though I spoke to a customer who was excited to open her first bank account at age 26 through the SafeStart program, another similarly enthusiastic consumer hadn't been able to open an account because a teller at Capital One hadn't heard of the SafeStart account—even though the bank is participating in the program—and told him that he needed to pay off lingering overdraft fees on an account he had already closed. It's also harder for customers who have wound up in the ChexSystem, a blacklist used by banks to identify problem customers, to get another chance through SafeStart.

Felix Salmon, a Reuters financial writer who is also on the board of the Lower East Side Peoples' Federal Credit Union, appreciates the efforts of the Office of Financial Empowerment but worries that it is constrained by its relatively limited budget. All the financial-empowerment centers, including the one I visited at the credit union, are dependent on funds from pri-

BRIAN STAUFFER

I ask Flax, the M&T Bank vice president, if New York's combination of financial education and safe-banking products could be a model for other cities. "Would it work in Cleveland? Maybe Pittsburgh? Or Dayton? My suspicion is that it wouldn't," he says. Indeed, though the Department of Consumer Affairs co-founded, with its San Francisco counterpart, a national organization called Cities for Financial Empowerment, the spread of these ideas has been limited.

Flax is more optimistic about San Francisco's Bank On model, which is now being adopted by six states and 56 cities around the country. Though the original program has a broad reach—48,000 new accounts in San Francisco, 40 percent of which come from low-income neighborhoods—it also has serious drawbacks. Unlike the SafeStart account, Bank On doesn't set clear standards, offering only guidelines for limiting fees and improving access, which increases bank participation at the expense of riskier accounts. Financial education isn't a mandatory part of the program, either.

While Bank On provides a model for cities that don't have a strong bargaining position with the banks or the money to fund a more expansive marketing and education campaign, these compromises do weaken the positive effects of getting people banked. The Treasury Department has requested $50 million to spread these ideas nationwide, though it remains to be seen whether the administration will leverage federal power to impose national standards.

While SafeStart and Bank On may prove difficult to spread widely, New York offers another program, called $aveNYC, that has nationwide potential despite the fact that it is also privately funded. The program began when the Department of Consumer Affairs found that tax preparers were ripping off low-income consumers. The department began providing free tax preparation and found that tax time was an opportune moment to introduce people to poverty-reducing behavior.

$aveNYC accounts are part of an effort to kill a flock of birds with one stone. First, they steer low-income people away from predatory tax-preparation services that make loans in advance of an expected tax refund. Second, they make sure that those who are eligible for the Earned Income Tax Credit apply for that assistance. Finally, they encourage savings by asking consumers to save half of their tax refund and matching that amount with private donations in the special account. $aveNYC demonstrates how a regulator can utilize the knowledge that comes from supervising financial firms and accessing consumer complaints, mix in a little behavioral economics, and create a program that helps people build income.

"That's the best program OFE has, and it could definitely be rolled out," Salmon writes. In Congress, several bills have been proposed that would create a program called the "Saver's Bonus" that is very similar to the $aveNYC accounts. The Saver's Bonus program has the support of the Obama administration, but while savings incentives like these generally attract bipartisan support, the idea of a public-private partnership to create safer financial products more broadly is controversial.

It remains to be seen if President Obama will strengthen safe-banking programs by imposing national standards.

Last year, as part of Congress' post-crash attempt to overhaul the country's financial regulatory regime, the House of Representatives passed a bill that included the consolidation of existing federal consumer-protection regulation—seven agencies and 17 statutes—into one independent agency, the Consumer Financial Protection Agency. However, the CFPA was banned from creating "plain vanilla" financial products because conservatives saw the move as government overreach. While it was a setback for reformers, it's not deadly. Some believe that banks would not have emphasized those products anyway, and the real importance of the agency lies in its overall rule-making capability.

BANNED BY NIXON? IT IS CERTAINLY LEGAL IN THAT THE STATE OF N. DAKOTA OPERATES A STATE BANK.

"For me to get people into banks, I need to be confident they won't be ripped off," says Julia Gordon, senior policy counsel at the Center for Responsible Lending, when I ask her about the problem of the unbanked. CRL, which is affiliated with a nonprofit bank called Self-Help, has long advocated practical consumer protections. Gordon worries that even if these safe accounts can move the unbanked into a more responsible financial situation, the temptation for banks to sell them new products that aren't as safe would be irresistible and could lead to a new cycle of predation.

This is perhaps the New York program's most important argument for a new consumer regulator on the federal level: Financial products have gotten so complicated and dangerous to consumers that local authorities had to step in to make something basic enough for everyone. Now, broad rules are needed to make predatory financial products the exception, not the rule. In his conversations with me, Mintz makes clear that local (and state-level) regulators are closer to customers and have a different set of tools they can leverage to supervise the consumer-finance market. Indeed, part of the new agency's mandate is lifting federal restrictions on lower-level regulators that often prevented them from acting during the last crisis, and Treasury officials recognize that different unbanked populations require different approaches. Nonetheless, to make a significant dent in the banking system—to regulate the big banks that surround Mintz's office—requires a broader, national agency.

Like the New York Department of Consumer Affairs, the CFPA aims to be responsive and complaint-driven, able to spot new rip-offs and act quickly. It will also house an Office of Financial Literacy that will have capacity similar to the OFE, providing opportunities for consumers to learn how to manage their money. Perhaps the most important lesson from New York is about leverage and doing as much as possible with limited authority. While the CFPA is banned from mandating that banks provide certain products, it is likely that the new agency could come up with criteria for financial products that would allow interested banks to apply for a government-approved status. That would be a huge step forward. Consider this comparison: If FDIC insurance were optional for banks, would you have your account at a bank that had the insurance or one that didn't?

"The CFPA would be on the frontlines of what frauds, scams, abuses, or problems are happening," says Assistant Treasury Secretary Michelle Green, who works on financial-access issues. "That would be great information to fold back into how we focus our outreach, resources, and education. Marrying those two things would be terrific."

It's too soon to say whether New York's program or it's West Coast cousin, Bank On, are the most effective ways to reduce the unbanked population, but early studies reveal both the promise of these programs and public demand for them. On a national level, the convergence of anti-poverty and regulatory policy may be hindered by the fraught politics of regulation and the difficulties of finding the funding for a new anti-poverty program. The lessons of New York show, however, that a consumer regulator can both restrain the worst practices of banks and cooperate with them to promote anti-poverty goals.

"Our role is to be unique, value-added, rather than hegemonistic," Mintz says, brushing off concerns that government is interfering too much in the financial sector. "It's our mandate to make people's lives better." TAP