
Subject: FW: Who caused the economic crisis?

Who caused the economic crisis?

Economist Simon Johnson and "Obamanomics" author John Talbott say there's plenty of blame to go around

By Simon Johnson and John Talbott

Jul. 22, 2009 |

John R. Talbott is a former investment banker with Goldman Sachs and the author of "The 86 Biggest Lies on Wall Street," "Contagion," "Obamanomics," and "The Coming Crash in the Housing Market." His books predicted the housing market crash, the financial crisis and the election of Barack Obama when Obama was still a little-known underdog. Talbott is currently engaged in trying to build what he calls "a grass-roots movement of ordinary Americans who want to take back the government from lobbyists and corporate interests." Anyone interested in learning more can e-mail him at johntalbs (at) hotmail (dot) com.

Simon Johnson, the former chief economist of the International Monetary Fund (IMF), is the cofounder of BaselineScenario.com, a Web site tracking the ongoing financial crisis. He is also the Ronald A. Kurtz professor of entrepreneurship at the MIT Sloan School of Management, a member of the Congressional Budget Office's Council of Economic Advisers and a senior fellow at the Peterson Institute for International Economics in Washington, D.C. He is one of the most visible public commentators on the ongoing financial crisis and its causes and on what role the government and regulatory policy will play in moving the economy forward.

From June to July of 2009, Talbott and Johnson held an e-mail conversation on the following topic:

"The economic crisis: Who caused it? Was it preventable? Was criminal activity involved in bringing it about? And is it over?"

The exchange below is the first of three sets of e-mails.

From: John Talbott

To: Simon Johnson

Subject: A Vast Criminal Enterprise

Simon,

I believe economists are doing a very poor job of explaining to the American people who and what caused the current economic crisis. I think the reasons for this are threefold.

One: Economists and media pundits -- themselves mostly gentlemanly elites anxious to please corporate America -- are slow to make the accusation that what happened here was truly

criminal, and so miss the real story. The American people understand that when a group of bankers shuffle some paper unproductively and get away with hundreds of billions of dollars in bonuses, yet cause a loss of \$40 trillion in global wealth and cause approximately 100 million people to become unemployed worldwide, there is only one word to describe it: criminal. We don't have to argue about whether their actions were technically illegal or violated existing statutes, as in this conspiracy the crooks were writing their own regulations and legislation through their control of the government through lobbying.

Two: There has been no criminal investigation to date, so evidence supporting criminality has not been uncovered -- no one is looking for it. Liberals hate to think that Obama, led by Geithner and Summers, is part of a grand cover-up scheme, but that is exactly what is going on. How else can you explain the lack of criminal investigations? Why isn't the FBI breaking down the doors of the commercial and investment banks and grabbing computers so as to preserve incendiary e-mails that will most definitely implicate executives? Why are managements that caused this still in their jobs and still receiving bonuses? Are the bonuses paid to the folks at AIG that caused its collapse nothing more than hush money? How can the rating agencies still be in business? Why don't we make one arrest and lean on the bankster to see if he will fold like the cheap suit that he is and name other conspirators? The FBI spends more time investigating \$2,000 drug buys than they have to date investigating the biggest heist in the history of the world: \$40 trillion, that's trillion with a T, that's 40 million bags each containing \$1 million.

The third reason that we have not had an easy-to-understand explanation from economists as to the cause of this mess: I think we're all trying to fit the facts as we know them into one simple story of causation. I believe there are actually three different storylines occurring contemporaneously, and all of them criminal. It is similar to what Winston Churchill said about trying to forecast Russia's next moves in 1939: "It is a riddle, wrapped in a mystery, inside an enigma."

So what are these three criminal storylines? The first, and the smallest (if you can believe it) at approximately \$10 trillion, is the housing crash and the mortgage meltdown. Totally criminal, as its primary cause was banksters stuffing worthless mortgage paper into CDOs [securities known as collateralized debt obligations] and calling them AAA. Criminal at every level, as real estate agents were convincing their buyers to pay more, not less, to "earn" their fees through a winning bid, appraisers were offering non-independent and completely tainted appraisals, mortgage brokers were altering loan documents and changing income data to qualify buyers, bankers were paying rating agencies to call junk paper AAA, and principal investors like pension funds, insurance companies, and sovereign governments failed to perform even the minimum levels of due diligence demanded by their fiduciary duties.

But the second story is even bigger and extends far beyond mortgages to the entire banking system. The banks had found a way to avoid the regulation that everyone knew they needed ever since they were given federally backed depositor insurance to prevent bank runs back in the '30s. They became one of the biggest lobbyists and campaign contributors to your Congress and your presidents. Then, amazingly, they just asked that all limitations on their activities be removed -- and they were. If I paid you \$2 for your vote, it would be illegal, but somehow these banks could pay hundreds of millions to our congressmen and presidents for their votes and it was all perfectly legal. Completely nuts!

So what did banks do that was criminal? Well, first they paid your government to eliminate bank restrictions, then they overleveraged, knowing they could not honor contracts with such leverage, then they lied to their shareholders about the risks and magnitudes of their positions, hid their positions illegally off balance sheet, and through the use of derivatives managed to violate minimum capital requirements on an almost daily basis. They took bank debt leverage

from 8:1 to over 30:1, thus assuring that the banking system could not survive even a modest credit tightening or recession. They made crazy bets in the credit default swap market that they could never honor in a downturn. They loaned money to anyone who could fog a knife because they knew they were going to stuff it to others through securitization and CDOs. If we had a criminal investigation, we would have access to the incriminating phone calls and e-mails in which the banksters disclosed what they really thought of the assets they were pawning off on others. To see how traders incriminate themselves, watch "The Smartest Guys in the Room," about Enron's collapse.

The final storyline of criminality is the biggest of all. It is bigger than the current financial crisis. It is corporate America's complete control of our nation's elected officials, especially our Congress, through lobbying and campaign donations. Yes, the banks played this game, but the game was much bigger than just the financial industry. Coal-fired utilities have so watered down impending legislation concerning global warming that they have now come out in favor of it in the House vote. TARP money went to banking friends of Hank Paulson, although 97 percent of congressional correspondence from the American people was against it. The credit card industry took a minor slap on the wrist, but faces no limitation on the egregious interest rates it can charge its customers. Pharmaceutical and hospital corporations are fighting hard to keep Americans from having a public alternative to their healthcare, and right now are winning that fight. The transportation industry is at the government trough trying to pass a \$500 billion windfall. The AARP prevents any meaningful reform of Social Security; the teachers' union does the same for education reform. Is it crazy to think that defense companies like Dick Cheney's Halliburton (which saw its stock price increase 700 percent during the Iraq war, thanks to no-bid contracts) may be promoting U.S. aggression around the world?

The American people understand that their government is corrupt; that is why they don't want to rely solely on more government regulation to solve this crisis. No, if we are to ever to see positive growth again in this country, we need to make the fundamental reforms that are necessary without relying on regulation which is so often co-opted or captured by those we are trying to regulate. This suggests we need to find a way to get corporations out of our government and ensure they never become either too big to fail or so big that they improperly influence markets and our government.

John

From: Simon Johnson

To: John Talbott

Subject: Re: A Vast Criminal Conspiracy

John

You make many good points, but I think the situation may actually be worse.

You stress that criminal acts must have been committed, and I'm sure this is right at the level of individual lenders or investment banks that packaged and resold dubious mortgages, for example. As you point out, when and if prosecutors get their hands on the right e-mails, we'll see evidence for a great deal of intentional deception (of consumers, investors, regulators and everyone else).

Given that we have a relatively decentralized criminal justice system, within which prosecutors have an incentive to build a tough reputation, and given that it takes time to build these kinds of cases, I suspect we will see more such prosecutions in the near future. Also, civil cases now under way may well uncover evidence of criminal wrongdoing -- and this will presumably be referred to prosecutors.

The bigger problem, however, is that much of what has severely damaged our economy and still jeopardizes our future is completely legal. Take, for example, campaign contributions. You rightly rail against these and the power that they confer on big donors -- primarily lobbies of various kinds. And we're all against direct favor buying that is presumably illegal. But much of what was done -- for example, in terms of financial market deregulation since the early 1990s -- was surely completely legal, but a very bad idea.

Bad ideas in public policy, of course, are always with us. What worries me most about our situation at this moment is that while our current leadership on economic strategy issues now talks about the mistakes of their (and our) past, their policies are pointing us back in the same direction. The latest evidence in this regard is the regulatory plan released by the Treasury this June.

This plan is a long list of technocratic tweaks. But when you dig through all the details, it is hard to find anything that will really make a difference to the functioning of our financial system. Most importantly, we will still have banks that are perceived as "too big to fail," and these institutions will have access to government bailouts under vague and completely open-ended terms. In what way will this encourage responsible lending in the future?

The administration does propose to add an agency protecting consumers against financial products -- and this is an implicit recognition that you are right, that the finance industry has long been ripping off consumers in various ways. But beyond that, there is nothing currently on the table that would make our banking system and -- by implication -- the world's financial system better run.

What happened? The finance industry has captured, intellectually, both public policy and a wide range of public intellectuals. People really believe that we need something like today's financial sector in order to resume reasonable growth in this country. This is despite the fact that financial innovation has added little to productivity in the past two decades, and it flies in the face of the obvious damage done recently by overborrowing at various levels.

You point out specifically that economists have not done a good job in terms of explaining the deeper causes of the crisis, and I would agree with that. But again I think this is due to the wrong mental model more than anything else. Most economists think that if we're talking about Indonesia or Korea or Russia, considerations of political economy -- i.e., who has power, what they are trying to do, etc. -- are first order. But as soon as we start to talk about the United States, many reasonable people think that the same special interest politics are second order and that the real action comes from more technical considerations, such as the "business cycle" (whatever that really means).

Implicitly, many economists see the U.S. as quite different from those middle-income countries often called "emerging markets." If these economists allow politics into their view of the world, they consider how altruistic policymakers try to balance conflicting objectives. The U.S., supposedly, is not about the competition for power and influence between strong interest groups.

My own view is that we should be dubious whenever someone says or assumes that "the U.S. is different." Most countries have powerful groups -- almost always including the financial sector, and big banks in particular -- and they are always trying to slant things their way. The U.S. may in fact have a worse problem, as our financial sector made a great deal of money in the early deregulation years of the 1980s and plowed that back into further financial influence.

Big finance, of course, was helped by two major waves of innovation: lower communication costs meant that global investing became cheaper, and lower computing costs meant that more complicated trading strategies (i.e., involving derivatives) became more profitable. Of course, to really take advantage of these changes the finance industry needed new rules: lower barriers to capital flows across borders and no regulation for derivatives trading. When they got both, by the mid-1990s, it was off to the races -- the unsustainable rise of the financial sector since that time is what has really pulled us into our current predicament.

And the way in which the Obama administration is attempting to extricate us from the crisis -- with unconditional support for big banks, regardless of costs -- is not addressing the fundamental imbalance of power that favors the financial sector. If anything, the big banks that survive in this sector have now become more powerful -- the political market share of JP Morgan Chase or Goldman Sachs has increased because Lehman and Bear Stearns are out of business.

Private equity and hedge funds, which could have been brought on board with a more reformist agenda (as they have no great love for supersized big banks), instead are lining up with everyone else for government subsidies of various kinds (e.g., through the toxic asset purchase programs organized by the Treasury). And small banks -- who have considerable potential clout through their access to the Senate -- devote most of their time to shooting down sensible changes to more general financial rules (e.g., about whether mortgages can be modified in personal bankruptcy), rather than helping to rein in big banks.

In some sense, the administration's political strategy in this area is not going at all well. But in another more profound sense, the political strategy of Big Finance is proving incredibly effective. They survived the crisis essentially intact, they will keep the rules that have served them (but not us) well, and their day-to-day influence in the corridors of Washington power has never been higher.

There will be a continuing struggle for reform -- after all, we've seen overbearing financial power reined in before in this country (e.g., by FDR and Congress, following the Pecora Hearings in the early 1930s). But it's going to be a long struggle. There is nothing on the immediate horizon that will address our fundamental problems; in fact, the economic recovery will further strengthen the hand of the largest banks, as they will argue that we should now "move on."

But as long as people like you keep writing about the deeper issues at stake, and -- by all means -- pushing everyone to look for and expose criminal wrongdoing, we will eventually move in the right direction. The battle to control finance is really an argument about ideas. What is the right way to organize the economy? How should big banks be effectively brought under control? How do we prevent anyone from exercising disproportionate influence in our open political system?

Keep at it.

Thanks,

Simon

"I would shut down the hedge fund industry"

Jul. 23, 2009 |

John R. Talbott is a former investment banker with Goldman Sachs and the author of "The 86 Biggest Lies on Wall Street," "Contagion," "Obamanomics," and "The Coming Crash in the Housing Market."

Simon Johnson, the former chief economist of the International Monetary Fund (IMF), is the co-founder of the Baseline Scenario, a Web site tracking the ongoing financial crisis. He is one of the most visible public commentators on the ongoing financial crisis and its causes.

From June to July of 2009, Talbott and Johnson held an e-mail conversation on the following topic:

"The economic crisis: Who caused it? Was it preventable? Was criminal activity involved in bringing it about? And is it over?"

The exchange below is the second of three sets of e-mails. The first pair was published Wednesday, and the final pair will appear Friday.

From: John Talbott
To: Simon Johnson
Subject: Complexity With No Purpose

Simon,

You make some very good points [in your first e-mail]. Let me try to address some of them, and in so doing extend this e-mail exchange into a conversation about the real reforms needed.

Don't worry, this isn't over yet. We haven't missed our chance to enact real reform. There isn't going to be any big recovery until we address these fundamental issues. Given the debt overhang, the banks' general unwillingness to lend, the lack of transparency and trust in the markets, the possible change in people's desire for increased status-seeking through crazy borrowing and crazy consumption, a substantial decline in immigration and population growth, and the fast approaching retirement of the baby boomers, I don't see the American economy growing in real terms for years, if not decades, into the future. The real risk is that the economy will continue to suffer, unemployment will increase, and discontent will grow to the point that the Republicans stage a comeback. It may sound far-fetched now, but I can tell you: There is enormous anger out there about government spending, the increased debt, the bailouts and the fact that Washington is still taking orders from special interests. This is not the change people signed on for.

You are right -- this is much bigger than Bernie Madoff and his friends stealing billions from investors. Because the banks lobbied to change the law before they acted, their actions are technically legal. But paying elected representatives money to change laws so that you can violate them seems to me to be at the heart of what criminal activity is all about. But you are right, because the laws were changed, criminal prosecutors in the states are not going to be very effective in bringing effective prosecutions, especially given that federal enforcement agencies like the FBI and the SEC [Securities and Exchange Commission] are collecting so little useful evidence and pursuing so few leads.

It is a real question how a country can stop corruption once corruption reaches its legislature, since the legislature is the place where we would expect reform legislation to be enacted. I

believe this is one of the reasons why the poorest countries of the world have remained poor for centuries. As we have seen here in the U.S., once you lose control of your legislature, accomplishing real reform is a much bigger problem. Prosecuting attorneys are not going to be much help, judges and the court system have their hands tied by corrupt legislation, and well-meaning presidents face ostracism inside the Beltway if they openly oppose Congress, lobbyists and corporate special interests.

I believe pressure for reform has to come directly from the people. And I believe that Washington is so corrupt that attempts to bring reform through the vote will be ineffectual. The two parties have too much of a lock on power while incumbents have too much money (and they have gerrymandered their districts to the point that their losing is near impossible). Congress' approval rating of 14 percent and congressional incumbents' 98.4 percent success rate at re-election fully describes the problem of attempting reform through the vote.

That is why I am starting an effort to organize Americans who are angry with the power of corporate special interests to take back their country by putting pressure not on the corrupt Congress, but on the source of their funding: our biggest banks and corporations. Follow the money. [Anyone interested in further information can contact Talbott at johntalbs (at) hotmail (dot) com.] The task is getting Americans organized, because once organized we hold the ultimate trump card. It is we Americans who make these corporations what they are today by buying their products and services. Any threat to not buy the products of big government lobbyists would certainly get their attention. I honestly believe it is also in the interest of our biggest corporations to stop influencing our government, because until they do, so our country is not going to be seeing any real economic growth. Banksters, greedy healthcare companies, a weak education system, unnecessary wars and a bankrupt government trying to fund its retirees' costs are not conducive to economic growth, and the corporations should come to realize this. This is a classic collective-action problem where each corporation cheats and steals a little, but the overall effect is to strangle the economy and prevent a truly prosperous future.

Of course, the real reforms that need to be accomplished, once we get corporations out of Washington and politics, include limiting the leverage of banks and prohibiting them from risky activities -- principal trading for their own account, derivatives trading, and many other investment banking activities -- and assuring complete transparency of all of their positions. We also need to strengthen the board supervision of management by getting managers, including the CEO and his cronies, out of the boardroom and replacing them with real shareholder representatives. We don't need to limit compensation, but we need to make sure that it is structured so that toxic waste cannot be left behind by a poorly thought-out bonus system.

But there are bigger reforms that are also needed. We need to downsize all corporations, especially the banks. We need to make sure they are not too big to fail. This downsizing will not hurt investors, as they will get two new smaller company shares of equal worth for every big old company share they held.

We need to shut down the credit default swap (CDS) market, because extensive trading of default risk makes everyone too interconnected to fail. I know the CDS market was created to limit risk through hedging, but it has done just the opposite. It has made all firms so interconnected that one cannot fail without bringing them all down. This violates the first rule of capitalism -- that firms must be allowed to fail -- and therefore it needs to be stopped completely. The only analogy I can think of to demonstrate how crazy this market has become is to go back in history to the early days of risk sharing when well-capitalized institutions on shore offered insurance against the loss of a ship at sea. The CDS market, if it were operating back then, would have allowed ships at sea themselves to guarantee the fate of other ships at sea, with very small boats such as hedge funds somehow insuring the return of very large merchant

ships. The whole mess would have become so interconnected that one ship's sinking would have bankrupted everybody.

People today seem to think that just because two people want to trade something, it must be good. Because the CDS market is big, it must be useful, goes the argument. It gets at the belief system that you suggested people have adopted: that markets are inherently good. Maybe always efficient, but not always good. There are some things like company default risk that shouldn't be traded. In the past people wanted to buy and sell slaves, child pornography, women's bodies, or weapons of mass destruction, or to offer payments to elected government representatives and bribes to international governments and competitors. Just because a market can develop does not mean the functioning of that market is good for society. Markets cannot self-reflect. That is what humans do. Only we can decide if a particular market is doing more harm than good.

I would extend my reforms to include shutting down most derivatives trading. If used properly, it can be an effective hedging tool, but since its introduction it has made investment analysis moot, as no one actually knows what risks you are buying when you buy the stock of a company or bank actively engaged in derivatives. You may be bullish on gold prices, so you buy a gold mining stock -- only to find out that the company has in fact hedged its gold exposure so effectively through derivatives that it makes money only if gold prices decline, not increase.

Similarly, I would shut down the hedge fund industry. They are nothing more than enablers for these banks and companies like AIG to concoct schemes to avoid regulation or increase risk. Basic investment theory says you can't beat the markets, so I will bet that the hedge funds that are claiming to do so are doing it illegally through insider trading and market manipulation of individual stocks and asset prices. Don't take my word for it. Let's have the government tap the phones and check the e-mails of the hedge funds for a six-month period on a confidential basis and see what happens to their reported outsized profitability and trading brilliance.

John

From: Simon Johnson
To: John Talbott
Subject: Re: Complexity With No Purpose

John:

Thanks for your follow-up note.

I take your point that there should be a great deal of popular anger -- there is certainly plenty of reason for ordinary voters to be upset. But I'm not so sure this will be manifested anytime soon; for most people, what has happened is a bit abstract and rather too confusing.

On top of this, the big banks have done a great job of muddying the waters. Their message gets through to many: Everyone is to blame and no one is responsible for the crisis, so let's go back to some version of business as usual.

I actually agree there will be change, but I would suggest three other ways in which this will be manifested.

First, the financial sector has become so bloated that going back to any version of "business as usual" is inherently difficult. Even ardent supporters of the financial sector think that much of its supposed growth since the mid-1990s is likely to evaporate. And there is no one who thinks that finance can continue to expand its already high share of our national economy.

In our bubble/boom, we overbuilt, just like Japan overbuilt in the 1980s. Japan added excessive commercial real estate and too much manufacturing capacity; it took more than a decade to work off that overhang and the associated corporate debt. We overbuilt residential real estate to some degree, but mostly we overbuilt financial services. That overhang could disappear fast -- buildings decay over time, but financial services are just people sitting in front of computers. Turn off the perceived business model and there's nothing left -- except perhaps too much office space in former financial centers.

Of course, it is possible that this aggregate contraction will come in terms of exits by smaller players in the financial markets, rather than downsizing the biggest banks. This would be ironic and also dangerous -- the real problem we face is from the banks and other financial firms that are "too big to fail" because they are so large relative to the financial system. If the biggest banks end up increasing their political and economic market share, this would not be good.

In this context, my second potential mechanism will be important. As you suggest, much of what passes for "financial innovation" is actually various ways to rip off customers. The biggest, most "sophisticated" banks have become very good at getting people to overpay.

Resistance to this kind of overpayment is growing. The existing level of fees, implicit and explicit, for all kinds of financial services has moved from irksome to completely unacceptable. Disappointed customers and rising competitive pressures are forcing these fees down. All of finance will be affected, but the biggest hit should be on the banks that are more about "rent extraction" than actually intermediating money from savers to borrowers.

The big banks are definitely in this line of fire. You're going to see some aggressive new entrants, undermining all manner of previously effective cartels, at the same time as fewer transactions and lower fees.

Third, there is great frustration and mounting anger among other members of our business elite. What the big banks have gotten away with is absolutely not in the interest of "real economy" entrepreneurs and the venture capital that backs them financially. It's also not in the interest of small and medium-sized banks who find themselves under increasing pressure -- particularly as commercial real estate goes bad -- but who are small enough and politically unconnected enough to fail. And the executives who run large nonfinancial corporations are beginning to figure out how badly they got clobbered and by whom.

They are worried about the budget deficit, about the issue of money, and -- most of all -- about their future taxes. All of these worries are completely appropriate. And they understand very clearly who is responsible: the biggest of the big banks.

Why does this matter? These business elites wield great influence, partly behind the scenes. They are increasingly articulating to their contacts in the administration and on Capitol Hill that "too big to fail" is no longer acceptable.

I hear more and more, including from influential people in the financial sector, that there needs to be some sort of "tax" (speaking loosely) on size in finance. There is a growing consensus that if you are big enough to jeopardize the financial system and to require a future bailout, you should pay for that privilege.

The payment can be in terms of higher capital requirements or something else. There are many ways to make this work -- as Deng Xiaoping said, "It doesn't matter if the cat is black or white, as long as it catches mice." The cult of size within the financial sector is over.

Overall, I may be more optimistic than you about change for Big Finance being on the way. But I'm probably less positive about where this ends up more broadly for society. You have a long list of reforms throughout society, and while we can argue the details, I'm broadly sympathetic to many of your points.

These mechanisms for imposing change on Big Finance, however, would do little to move things forward on a broader front.

That needs a more comprehensive national leadership push. Personally, I have not given up on President Obama -- I think much of his strategic agenda makes sense and many of his tactics are sensible, but the banking crisis is still an Achilles' heel. If he can get past that, and put the big banks back in their (smaller) boxes, I'm optimistic that he will have the opportunity to push over time for more extensive reforms.

And if not him, who?

Thanks,

Simon

Jul. 24, 2009 |

From: John Talbott

To: Simon Johnson

Subject: Taking Back the Country

Simon,

I think you and I and most economists suffer from an antiquated belief that if we can just figure out exactly what went wrong, policymakers will beat a path to our door to ask our help in enacting necessary reforms. Unfortunately, the world no longer works that way. Our corrupted government, our criminal businesses and banking institutions, lobbyists, special interests, and the corporate controlled media are not interested in fixing this problem. They are making trillions of dollars through a vast scheme that transfers wealth from ordinary American taxpayers and consumers to their corrupt coffers. You are right that if big business thought about it, they should support efforts at restricting lobbying so that growth-oriented government policies could be implemented without the influence of corrupting special interests. But each lobbying corporation is also its own special interest, and so such internal reform is impossible.

The million-dollar question is: Why haven't ordinary Americans reacted more passionately and angrily in taking real action to end this systemic abuse? A decade ago, I wrote my first book on the corrupting influence of big business lobbying on our government and concluded at the time that average Americans would not focus on the issue until they had suffered real pain. I concluded that you can't defuse a bomb in America until after it has gone off.

But now the bomb has exploded. Forty million Americans are unemployed, millions have lost their homes, and most have taken a very substantial hit to their incomes, retirement savings and wealth. Why aren't Americans in the streets protesting this corrupt, enormously damaging criminal enterprise? I have traveled enough around America to realize that even though the current situation is enormously complex and not all Americans can describe exactly how the CDO

market works, almost without exception every American can relate to you his frustration with how corrupt this government is and how unjust corporate lobbying and special influence in Washington has become. They get it. As a matter of fact, some of my high school-educated friends from my home state of Kentucky understand it a lot better than my Harvard-educated friends from Wall Street.

So I don't think the current challenge is figuring out exactly what caused the crisis. Focusing on what caused this episode will lead to narrow regulatory reform that reminds me that we all now take off our shoes at airports because one crazy fellow had the idea of putting a bomb in his heel. So while reform is needed in subprime mortgages, securitization, derivatives, and even in the magnitude of our financial institutions, none of these get at the fundamental problem: The people of this country are no longer making the rules by which they wish to live. If subprime mortgages hadn't blown up, some other area of highly leveraged bank lending would have eventually imploded. Even if the banking industry hadn't crashed, some other sector of the corrupt business/government criminal enterprise would have. Maybe the ice shelf of Greenland would have collapsed into the North Atlantic, maybe we would have run out of oil, maybe Microsoft's monopoly position in operating systems would have led to a worldwide computer virus shutdown, maybe poor consumer safety standards with China would have led to a global disease epidemic. The point is that when corporations make the rules, the results are not always good for the inhabitants of the planet.

So we don't have to decide today exactly what the reforms will be -- we just need to get corporate America out of our government so that the people can deliberate and make these reform decisions themselves without undue influence from bankers and corporations.

But there are two huge impediments to accomplishing this. This is not a traditional economics problem, it is an organizing problem or a collective action problem. People know the system is rigged and broken and unjust, but they feel as if there is very little that any one of them can do to effect much change. The organizing task is further complicated by the fact that our media, including television networks, cable TV, radio, newspapers, and magazine and book publishing, are almost all sponsored, owned and controlled by big corporations. The only hope is the Internet, over which big business has tried but to date failed to successfully exert its dominance. The Internet will prove to be both a source of unbiased news and information as well as the communication tool concerned citizens can utilize to fight back against big government, big business and big media.

What has to happen to get this movement started? First, I think people need to see that there is a channel being constructed that has the potential to be effective in directing their anger into real positive reform and change. I am in the process of beginning just such an organization and encourage people who are interested in fighting back against the system and against corporate lobbyists and special interests to contact me at my e-mail address below.

Next, people have to believe that if they invest their time in such an effort they have the potential of winning. In this case, this is rather straightforward and easy to explain. If we are successful in organizing 5 million to 10 million Americans who want to see real change about how business is conducted in Washington, then by definition, we will have not only substantial political and voting power, but more important, the beginnings of a real consumer movement that could easily boycott the products and services of the worst corporate lobbyists in our government.

And this is where the magic of the Internet comes in. No one person could organize a 10 million person database in his lifetime. But Obama was able to accomplish it in less than two years. How? We don't have his money. Instead, we create our own Ponzi scheme. We create the

ultimate chain letter. I e-mail 30 of my friends who each e-mail 30 of their friends and so on and so on. If only four cycles of people pass on the info we end up contacting 25 million Americans. We ask people to give us their e-mails and then contact them when we want to boycott a new offender.

It is time for Americans to realize that things are not going to improve until they get involved. It will take time. But the economy is not going to improve until we straighten out our corrupt system. Do you have anything more important that you are working on than this? The survival of liberal democratic society in the world.

Thanks for a great exchange of ideas. And best of luck in your future research and work.

John

From: Simon Johnson

To: John Talbott

Subject: Re: Taking Back the Country

John:

I admire your energy and focus in trying to mobilize a broader cross section of people against the big banks in particular and the way our political-financial system operates in general. I'm sure this is worthwhile and not at all a waste of time. Any efforts you or others put into educating people -- or enabling people to better educate themselves -- will surely pay off over time.

However, my sense of the political cycle around these issues is perhaps a bit different from yours. On the first round -- the crisis, immediate policy response and first-round "reform" efforts -- the big bankers have definitely won.

You were right when you argued way back that it would take a crisis before anyone really understood that we have a problem. But even so, most people still do not fully understand what has happened to them over the past 12 months -- and why their future taxes will be so much higher. I spend quite a lot of time talking to relatively well-informed people. After an hour or so of intense discussion and argument, I would say that most people see much more clearly just what the big banks got away with, although they do not necessarily agree with the idea of stricter regulatory controls on those banks. Left to their own devices, or just relying on the usual sources, I'm not sure how clear any of this is to most people.

And I worry that e-mailing friends doesn't necessarily engage people at the necessary level. You need repeated reinforcement of the key themes -- and a lot of back and forth with people you trust -- to really change minds on something this big. Or, as you say, you need to see it again and again, and perhaps you need to worry about the consequences for your own well-being.

If the big banks could just lie low for a while, I honestly think they would get away with everything -- the backlash would fade, and we'd be setting ourselves up for another massive crisis down the road.

Fortunately (in a sense), the banks cannot back off from their most egregious behavior. Perhaps this is in their DNA; definitely it is in their organizational culture and how they see the world -- the people who run the biggest financial institutions really think they are the masters of the universe and are proceeding on that basis.

Their profits, their wages, their bonuses, and their behavior have begun to antagonize people greatly. Already, some of my contacts who are close to the administration wince at the latest news from the financial sector, be it the bonuses that were paid last year to senior people who oversaw major mistakes (some of whom are now rewarded with senior policy roles!) or the blatant bragging about political influence that some CEOs are now making public.

And even if some sensible people at these banks would like to rein in employee compensation to more moderate and reasonable levels, they have a problem. If you lower the wages for your people, another bank -- perhaps one based in Europe -- will hire them away with a crazy package. The rat race, across companies and between people, means that this can only be curtailed through regulation. But the survivor banks are so strong politically that they will defeat all meaningful regulation for compensation.

This very success makes them more vulnerable to further criticism and backlash.

I'm not saying that the banks will simply commit political suicide. Nothing is ever so simple. But they will likely undermine themselves with Congress and eventually even with the administration. The midterm elections in 2010 and the presidential election in 2012 could well be very much about restricting the power of the big banks.

American democracy does not get on well with overweening unelected individuals who pretend to great power. Andrew Jackson saw off Nicolas Biddle in the 1830s. Teddy Roosevelt stood up to -- and eventually towered over -- even J.P. Morgan at the beginning of the 20th century. And FDR remade everything in the 1930s.

As I said before, I'm optimistic that President Obama can do the same. The challenge to democracy is palpable and growing. The fact that two -- and only two -- big banks came through the crisis unscathed is a perfect symbol of the problem. In the past, part of the myth of Wall Street was that it was competitive, that many could enter the industry, and that its political power was not too concentrated. This myth, among many, has now exploded.

We see the power for what it is. Mainstream media increasingly picks up the story line. And still the big banks cannot step back and curtail their most troubling activities.

Keep explaining and let the big banks provide the supportive evidence you need.

Best wishes,

Simon

-- By Simon Johnson and John Talbott