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Will It Work?

The bailout bill has passed. But how will we know if it succeeds?

By Robert E. Litan

So, will it work? Now that Congress has passed the bailout bill -- an unprecedented riverboat gamble aimed at preventing financial meltdown in the United States and possibly around the world -- that's the question on everyone's minds.

In the short run, we'll know if it works by looking at the "TED Spread" -- the difference between the most commonly used interest rate for inter-bank lending and the interest rate on short-term government debt. This spread is essentially a measure of credit risk: because short-term government debt is considered almost risk free, the difference between the rate for government debt and the rate for bank lending is a good indicator of how risky it is for banks to lend to one another. The higher the spread, the greater the fear of default on inter-bank loans. It was when the TED spread spiked near an unheard of four percent that Treasury proposed the massive bailout in the first place, a bailout that will hopefully soothe the rattled nerves of banks and so they can resume lending to each other in confidence. If the TED comes down, we'll know that this has happened.

But we may not know immediately, since the devil is in the details -- and not just in the legislative details. The Treasury Department must still issue guidelines on how it's going to buy up the troubled mortgage-related and other asset-backed securities covered by the bill. Those guidelines may very well determine how eager the intended participants -- banks, insurance companies, pension plans, and so on -- will be to sell to the Treasury. In addition, the bill's well-intentioned provisions limiting executive compensation and giving the government an equity stake in firms that sell the securities may also discourage some of those firms from showing up at the bailout party -- to what extent, we simply won't know. And it may even be some time after the election before we really have a good idea about participation, because the Treasury's

purchasing guidelines might change when the new Administration takes office.

And the uncertainty doesn't end there. I doubt the public is aware that even the adoption of the Treasury plan may not avert the need for the Treasury and the Fed to do more institution-specific deals like the ones already done for AIG, Fannie and Freddie. This is because even if the plan can quiet the inter-bank lending market, the institutions selling the securities may only gain added liquidity -- that is, they'll have an easier time buying and selling assets -- but will not necessarily gain additional capital. There may be a large hue and cry if the government gives the financial institutions prices for the troubled securities that exceed the already marked-down values on the institutions' books. But unless that is the case, there is no way (at least that I can see) how this plan will add to the institutions' capital. Conversely, if the sale prices fall below the values currently shown on the books, then the banks and other sellers will actually lose capital, at least as measured under conventional accounting rules.

As a result, institutions in need of capital now are still likely to need capital after the plan is in place. If they can't raise it in private markets -- and in this environment, it may be a miracle if anyone can -- then the Treasury and the Fed will have to decide again, on a case by case basis, whether to inject public funds into ailing companies in exchange for stock. I'm not sure many in the public or on Capital Hill realize these hard decisions may be coming, especially if the economy continues to sink as rapidly as the latest jobs and other economic indicators suggest. But I'll bet this prospect is keeping beleaguered officials at the Treasury and the Fed up at night. I fear they (or their successors) won't sleep easy for a while.

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Low Expectations

Why should Sarah Palin benefit from the fact that the media expects her to do poorly against Joe Biden?

Low expectations might be the secret to happiness, but are they the secret to winning an election? The McCain campaign must be hoping so, and the Democrats are crossing their collective fingers that it won't be the case. But just about everyone seems to agree that Palin's gruesome performance in last week's interview with Katie Couric has given the Alaska governor an advantage in tonight's VP debate. CNN's Gloria Borger says that the bar that Palin must clear is "on the floor" and NBC's Savannah Guthrie commented this week that the McCain camp will be pleased as peaches if Palin "just survives." One Wisconsin political scientist told the press that Palin should be fine so long as she can avoid an "embarrassing massacre," as if she were about to debate Genghis Khan.

As a matter of historical prediction, these pundits are almost certainly right: Sarah Palin will be the happy beneficiary of low expectations. When you're near the bottom it's hard to go anywhere but up. (Sixty percent of the public now thinks Palin does not have the experience to be president.) And yet it seems equally true that low expectations are the wrong standard to apply to tonight's debate. In part this is because the media's expectations can be self-fulfilling: predictions can influence outcomes, especially when the people making the predictions are the very same people *interpreting* the outcome. And since the questions of who "won" the debate is almost entirely a matter of interpretation, doesn't the press have an incentive to prove itself right?

But the more important problem is that Palin is not running for vice president against herself (evidence from the Couric interview to the contrary), and the yardstick of past performance isn't the most important one. She is running against Joe Biden and, if we're trying to figure out who won the debate, she should be compared to him. When voters punch their ballots on November 4, they won't be deciding between the Sarah Palin who bluffed and fumbled her way through the Couric interview and the Palin who will appear onstage in St. Louis tonight. They will be choosing between two tickets, and they should pick the most qualified.

There are no prizes for being the most-improved candidate, even if voters can glean something valuable from improvement. There should be only one prize: for being the best candidate. Or at least that's what I'd like to expect.

The Chilling Innocence of Piracy

Somali pirates hijacked a Ukrainian vessel carrying tanks and other military hardware in the Gulf of Aden. U.S. Navy warships have surrounded them.

This year alone, pirates have attacked 61 ships in the region. They have held 14 oil tankers, cargo vessels, and other ships with a total of over 300 crew members, and have demanded ransoms of over \$1 million per ship.

The word "pirate" summons all sorts of romantic images from the great age of piracy in the 17th century Caribbean: a ship flying the Jolly Roger and manned by cutthroats with black eyepatches and sashes around their heads. The Indian Ocean pirate of the early 21st century -- in his flip-flops, tank-top, and light jacket -- is different in some ways but similar in others. Only through the distance of time can we find anything charming or romantic about Caribbean pirates, who were murderous thugs just like their modern-day Indian Ocean counterparts.

Piracy is the maritime ripple effect of anarchy on land. Somalia is a failed state with a long coastline, so piracy flourishes nearby, as it does offshore from other weakly governed states like Indonesia and Nigeria. But it is particularly prevalent off the Somali coast because the anarchy is far more severe than in the other two countries. The Somali civil war began in the early 1990s, but the country had, in effect, been broken up since a decade earlier. I was in Somalia in 1986; there was essentially no government at that time, and the country was a virtual ward of the United Nations. Then, Somali pirates were often unemployed male youth who hung around the docks, and whom the local warlord dispatched to the seas to bring back income for him. Piracy is organized crime. Like roving gangs, each group of pirates patrols a part of the sea. The waters in the Gulf of Aden might as well be a street in Mogadishu.

I spoke recently with several U.S. Navy officers who had been involved in anti-piracy operations off Somalia, and who had interviewed captured pirates. The officers told me that Somali pirate confederations consist of cells of ten men, with each cell distributed among three skiffs. The skiffs are usually old, ratty, and roach-infested, and made of unpainted, decaying wood or fiberglass. A typical pirate cell goes into the open ocean for three weeks at a time, navigating by the stars. The pirates come equipped with drinking water, gasoline for their single-engine outboards, grappling hooks, short ladders, knives, AK-47 assault

rifles, and rocket-propelled grenades. They bring millet and qat (the local narcotic of choice), and they use lines and nets to catch fish, which they eat raw. One captured pirate skiff held a hunk of shark meat so tough it had teeth marks all over it. With no shade and only a limited amount of water, their existence on the high seas is painfully rugged.

The classic tactic of Somali pirates is to take over a slightly larger dhow, often a fishing boat manned by Indians, Taiwanese, or South Koreans, and then live on it, with the skiff attached. Once in possession of a dhow, they can seize an even bigger ship. As they leapfrog to yet bigger ships, they let the smaller ships go free. Because the sea is vast, only when a large ship issues a distress call do foreign navies even know where to look for pirates. If Somali pirates hunted only small boats, no warship in the international coalition would know about the piracy.

Off-hand cruelty is the pirates' signature behavior. In one instance, they had beaten, bullied, and semi-starved an Indian merchant crew for a week, and thrown overboard a live monkey that the crew was transporting to Dubai. "Forget the Johnny Depp charm," one Navy officer told me. "Theirs is a savage brutality not born of malice or evil, like a lion killing an antelope. There is almost a natural innocence about what they do."

The one upside of piracy is that it creates incentives for cooperation among navies of countries who often have tense relations with each other. The U.S. and the Russians cooperate off the Gulf of Aden, and we might begin to work with the Chinese and other navies off the coast of Indonesia, too. As a transnational threat tied to anarchy, piracy brings nations together, helping to form the new coalitions of the 21st century.

Getting It

Barack Obama and John McCain both think they can win the election by accusing the other of not understanding America.

In Friday's debate John McCain said six times that Barack Obama doesn't "understand" foreign policy. The next day Obama released an ad saying "McCain doesn't get" middle-class economics. So McCain volleyed back via satellite, saying it's Obama who "doesn't seem to get" how seriously our bank system failed. Obama swung back harder, reminding a Detroit crowd Sunday that it was most certainly McCain who "just doesn't get it." And McCain finished off with an overhead slam, telling George Stephanopoulos on "This Week" that if there was any not-getting-it business in this race, it was surely the young senator who "does not understand, and did not understand and still doesn't understand" the situation in Iraq. All of which begs the question: Is tit-for-tat a strategy or a tactic?

As if Jim Lehrer's prodding the candidates to please "talk to each other" at the debates didn't sufficiently conjure the air of therapy, the next phase of the presidential campaign has become a discussion of that most personal and wishy-washy concept of understanding. Every time a candidate reaches the thesis of his argument, he claims the other guy just doesn't really get it.

"He doesn't get it" is an effective charge for a change election because it manages to indict all a candidates' policies in just thirteen letters. For both candidates, "getting it" is a cipher for their fundamental arguments. When John McCain talks about "not getting it" he's saying Obama's inexperience makes him unfit to handle serious issues. When Barack Obama talks about "not getting it" he's saying McCain is too old and too tied to the Bush administration to speak to middle class concerns.

"My opponent just doesn't get it" is also a nice little riposte when you don't have any real objection to what's just been said. One little secret of this campaign is that Obama and McCain's short-term policies are largely identical on foreign policy. Both candidates (and the president) tacitly back Iraq's request for a gradual withdrawal of troops in the first two to three years of their first term. Both candidates (and the president) would move troops into Afghanistan to roll back the Taliban's advances. Both candidates would almost certainly target Al Qaeda leadership in Pakistan if the government refused direct involvement. As Marc

Ambinder pointed out based on the cryptic testimonials of Henry Kissinger, the candidates aren't as far apart on Iranian diplomacy as the debate suggested. And both candidates have gingerly supported the bailout plan provided it has transparency, accountability and all those other check-box terms that candidates tack on when they're short on details or fresh ideas.

To be sure, a McCain administration would be very different from an Obama administration. What we have here is not, as Dr. Lehrer might suggest, a failure to communicate but a failure to deviate from a limited option of safe responses. The Iraq War has exhausted America's patience: What poll-perceptive candidate wouldn't talk about getting out? The Wall Street meltdown is devastating the stock market: Who's going to say no to a bipartisan rescue? Events in the Mid East and Midtown have placed such narrow restraints on what is considered mainstream politics that there's not enough space for either candidate to carve out a tough position without being accused of being a radical warmonger, peacenik or socialist.

That's why Friday was a debate about worldview rather than issues. It was entirely legitimate for Obama to say, as he did many times on Friday, that he agrees with John McCain but still finds his policies lacking an understanding of what makes America respected abroad and prosperous at home. And it was entirely acceptable for McCain to say, as he has many times, that even if he can't clearly distinguish his short-term Iraq plan from Obama's, his younger opponent doesn't earn an "A" for comprehension just because he's learned to praise the surge.

Although predictions in this race have a habit of becoming anachronistic in a week, it's worth pointing out -- at least on the morning of Tuesday, September 30, 2008 - that the "getting it" argument does not favor McCain. Obama's rambling professorial style is probably an overall weakness. But wonkiness is also the perfect antidote to McCain's accusations of ignorance. Every time McCain used the U-word on Friday, Obama would summon a swirling series of musings that, even if they failed to be entirely persuasive, at least sounded like a smart guy thinking through the issue.

In what increasingly looks like an economic election, polls show the public trusts Obama - a constitutional lawyer on a foreign affairs subcommittee - more than it trusts the third-decade Senate veteran on the economy. Maybe the letter after McCain's name is just tough luck but he hasn't convinced enough struggling middle classers that he can lift

them out of the muck of a looming recession. Rhetoric aside, the hardest part for McCain is that November will be decided, not by the candidate "who gets it" but by Americans who've got it bad.

It Failed

The bailout crashed, and so did democracy.

Democracy is not perfect, and one of its many imperfections is that voters tend to be ignorant. I don't mean to be insulting. There are, after all, perfectly rational reasons for this ignorance. In a republic of 300 million, the chances of an individual vote affecting a national outcome are slim, and it makes little sense for the individual voter to invest scarce resources in learning about complicated issues, like health care or foreign policy or, just to pick another subject at random, the economy.

A few hours ago the House of Representatives defeated the bailout bill. It was close, 228 to 205. And it was just about completely unexpected. The lead story in this morning's *Wall Street Journal* was "U.S. Seals Bailout Deal." Former Treasury Secretary Larry Summers -- no socialist, he -- had a piece in this morning's *Washington Post* ("A Bailout Is Just a Start") that treated the legislation as a *fait accompli*. The lead editorial in the same paper was titled "The Deal is Done." I'm pretty sure one of the *Post's* headline writers is regretting his word choice.

It is rare that a consensus at one level -- among policy analysts, journalists and professional economists -- is so thoroughly bucked by the mechanisms of democracy. This is not to suggest that the professional consensus is entirely comfortable with the bailout, or that the bailout doesn't impose real budgetary and moral hazards. But it is to suggest that the failure of the bailout is no great credit to democracy.

It's simple: The Republican and Democratic congressmen who voted against the bill were responding to angry constituents who thought of the bill as nothing more than a gift horse for the rich -- on CNN a moment ago a reporter said such constituents were phoning in "a hundred to one" against the bill. The congressmen who serve these constituents are afraid of losing in November, and they are pandering with shameless zeal and reckless abandon. Witness Republican Jeb Hensarling's unconvincing claim that the bill would put us on "the slippery slope to socialism," or Darrell Issa's peculiarly vivid argument that it would amount to "a coffin on top of Ronald Reagan's coffin."

Those angry constituents might be right, and their congressmen might be right to cater to them. But I doubt it. They might be laughing all the way back to Congress, but they sure as hell won't be laughing all the way to the bank.

And democracy is a fickle thing. I would imagine there to be a great deal of overlap between voters who complain about the long arm of the federal government and voters who complain about the plummeting value of their pensions. If that's the case, some of those No votes won't even be laughing their way back to Congress.

Debating the Bailout

Why did John McCain wait until the debate to announce that he supports the Treasury's plan?

Tonight's debate was supposed to be about foreign policy, but for obvious reasons the candidates spent the first half talking about the economy. (Everyone is having a hard time talking about anything else.) But there was one line of the debate exchange that stuck out like a happy investment banker. Jim Lehrer asked both candidates, plain and simple: Did they support the Treasury's bailout plan? Obama said he hadn't yet seen the full text and wanted to suspend judgment until he had. And McCain said, "Sure." In case no one heard it, he went and said it twice: "Sure."

I'm not sure what's happening here. Early this week McCain made a decision to suspend his campaign and fly back to Washington, citing the "historic crisis in our financial system." He said leadership was needed, not partisan rancor. He then spent the next two days brooding in enigmatic silence, playing an aloof game of legislative footsie with various members of Congress and the media, and generally letting the bailout negotiations descend into more of a partisan bloodbath than anyone expected. And now, safely out of Washington and back on the campaign trail, he mentions that he supports the bailout package.

Further bafflement: 15 minutes after the debate ended, the McCain campaign sent out an email to announce that the Arizona senator "will return to Washington to resume negotiations with the Administration and Congressional leaders from both parties to forge a bipartisan solution to our economic crisis," which is necessary because "We must put our country first to solve this economic crisis." Perhaps this was an error. Perhaps the campaign meant to say that McCain will apologize for his prior indecisiveness, stand foursquare behind Secretary Paulson, and admonish his fellow Republicans for making a hash of the negotiations by hauling in an obviously implausible counterproposal in the 11th hour. Or perhaps McCain did not mean what he said during the debate.

Reasonable people can disagree about Paulson's bailout plan in particular or the helpfulness of a bailout in general. McCain has done neither. He showed up in Washington, failed to agree or disagree with much of anything, and then left before a bailout was finalized. He was,

in a brilliant Kerry inversion, for it after he was against it. Except that I'm not longer sure he's for it.

And I'm not sure how this will play when McCain gets back to Washington. In tonight's debate, Senator McCain repeated a well-worn joke -- that he was never likely to be elected "Miss Congeniality" in the Senate. Such an election seems equally unlikely in the next few weeks. McCain's colleagues -- not to mention the administration, Wall Street, and the president -- can't be pleased with his behavior. It's a reason why he might not win in that other election, either.

Risky Business

Why Barney Frank and Chris Dodd's plan to regulate executive compensation makes economic sense.

Treasury Secretary Hank Paulson spent the first half of this week warning us that the executive compensation regulations proposed by congressional Democrats will appear "punitive" and scare financial institutions away from participating in the federal bailout. The fact that Paulson has now given in should please, among others, Congressman Barney Frank, who spent the week arguing that such regulations were an issue of fundamental fairness. In Frank's words: "I don't want the federal taxpayer to be at risk for their bad debt and then the guy who incurred the debt gets tens of millions of dollars on the way out the door."

I don't want that either, but both sides of this debate are missing a big point in favor of compensation regulations -- a point that has nothing to do with the degree to which the regulations are punitive or fair. Smart regulations could prevent the sort of compensation packages -- and incentive structures -- that helped get us into this mess in the first place.

To understand why, it's necessary to understand how executive compensation packages are structured. At present, salary comprises a very small slice of a finance executive's total earnings. Unlike most other companies, executive compensation at a financial institution is tied mostly to the institution's annual performance and doled out in the form of a year-end bonus. This bonus is invariably staggering (in Goldman Sachs CEO Lloyd Blankfein's case it was \$68 million in 2007), and it is usually split about evenly between rewards that are intended to create short-term and long-term financial incentives. Short-term incentives generally take the form of cash, while long-term incentives, which take several years to vest, include restricted stock units and stock options.

For instance, Morgan Stanley's 2008 proxy statement lays out its bonus structure as follows: "Pay levels should be determined based on company, business unit and individual results compared to quantitative and qualitative performance priorities set at the beginning of the year," and annual "profit before taxes and return on equity are key performance measures considered in making pay decisions."

The stated aim of this kind of performance-based compensation is to align executive interests with shareholder interests. But the emphasis on *annual* performance -- based on non risk-adjusted factors like profit and

return on equity -- means that executives are motivated to take major risks to maximize revenue and boost stock prices in the short term.

Although the long-term incentives built into the bonus are designed to reduce such risk taking, these incentives are still awarded for short-term success. If executives act in a prudent, risk-averse manner, they will receive a smaller pot of long-term incentives to protect on bonus day. It is thus rational for them to maximize their compensation by taking large risks. And the cash bonuses are often so large that an executive can float into gilded retirement even if his financial institution tanks. (Just ask former Merrill Lynch CEO Stanley O'Neal, who netted an \$18.5 million cash bonus in 2006.)

Creating an incentive to take risks can blind finance executives to the pitfalls of hazardous investment instruments like bundled subprime mortgages. This is a familiar insight. At a recent hearing of the House Committee on Oversight and Government Reform, Nell Minnow, co-founder of corporate governance research firm The Corporate Library, testified that compensation plans determined mostly on annual earnings and equity returns can "push for sales without adequate concern for quality."

Any bailout legislation passed by Congress should include a mechanism to limit bonuses that reward taking potentially catastrophic risks. Senator Chris Dodd's bailout proposal, which places "limits on compensation to exclude incentives for executives to take risks that the Secretary deems to be inappropriate or excessive," is disturbingly vague, but at least it is a start. And it might even be fair, too.

The Fall of Thabo Mbeki

Thabo Mbeki resigned as South Africa's president after almost a decade in office.

As Nelson Mandela's deputy, Mbeki played a central role in shaping post-apartheid South Africa. Once regarded as a man of rare promise, he has been a failure, not least by the lofty standards he set for himself.

Things could be worse in South Africa, as evidenced by the chaos and misery that prevails in neighboring Zimbabwe. But South Africa was once a model of racial reconciliation, a political miracle more remarkable in some respects than the collapse of the Soviet dictatorship. And under Mbeki, South Africa was supposed to spark an African renaissance. Instead, South Africa has grown increasingly violent and poverty-scarred, and even its vaunted tolerance is at risk. From his know-nothing crusade against the scientific consensus on AIDS, which was likely responsible for thousands of deaths, to his embrace of thuggish kleptocrats, Mbeki has endangered all that generations of ANC freedom fighters achieved. Having abandoned Marxist-Leninist economics, Mbeki also abandoned the ANC's anti-racism, choosing instead to embrace a cynical racial populism to mask the unpopularity of neoliberal reforms. It was a clever political gambit, but one that threatens to poison South African democracy.

On the economic front, despite fiscal and monetary policies that have garnered considerable praise for prudence and restraint, South Africa has barely outperformed the rest of sub-Saharan Africa. Despite a recent commodity boom, only a narrow slice of South Africa's population - a politically connected elite - has seen its living standards rise. From 1994 to 2006, per capita GDP grew at just over 1 percent; by way of comparison, per capita GDP in East Asia grew by over 6 percent. This abysmally slow growth has had a high moral cost. Thanks in part to an unemployment rate of over 25 percent, native-born South Africans harbor deep resentment of the hundreds of thousands of economic refugees who've settled in the country in recent years - resentment that boiled over earlier this year into ugly riots that left dozens dead.

Remarkably, South Africa is now poorer than in 1980, when it was a pariah state that denied vast swathes of its population access to education and basic political rights. The South African Constitution, an inspiring, carefully crafted document that is widely and deservedly praised, includes rights to housing and economic security and decent

health care, and looks to the "progressive realization" of these rights. But the reality is that the number of South Africans living in poverty has sharply increased since 1994, leaving these goals further out of reach than they were when the constitution was enacted. Meanwhile, large numbers of educated South Africans are fleeing the country in response to rising intolerance, further damaging the country's economic prospects.

Mbeki's successor, Baleka Mbete, is a cipher, a close ally of Mbeki's rival Jacob Zuma, who will almost certainly become president after elections in 2009. Zuma is a decidedly eccentric populist who has been accused of all manner of crimes, ranging from sexual assault to money laundering, and he is beloved by many on South Africa's left, who hope he'll reject Mbeki's fiscal discipline and dramatically increase social spending. Most analysts believe that Zuma is in fact very cautious, and that he will adhere closely to Mbeki's approach. This is tragic. Had Zuma been less cautious, had he abandoned the ANC to form a movement of the left with his allies in the unions and the South African Communist Party, he may well have created a genuine, vigorous multiparty politics. Instead, South Africa is going from one strongman to the next. One can only hope that Zuma is more enlightened than we have any right to expect.

Not Buying It

Why Secretary Paulson's plan to bail out the financial industry needs a better explanation.

We are embarking on the most radical transformation of the American economy since the New Deal, committing hundreds of billions in taxpayer money to save banks and other financial institutions from the consequences of their own bad investments. This, we are told, is the cost of averting a crisis. But I sure wish someone would explain to me exactly what crisis we're trying to avert.

What's clear is that a bunch of financial institutions have made mistakes and lost money. What's unclear is why anyone (other than the owners and managers) should care. People make mistakes and lose money all the time. Restaurants fail, grocery stores fail, gas stations fail. People pick the wrong stocks, they buy the wrong cars, and they marry the wrong spouses without turning to the Treasury for bailouts.

So what's special about banks? According to what I keep reading, it's that without banks, nobody can borrow, and the economy grinds to a halt.

Well, let's think about that. Banks don't lend their own money; they lend other people's (their depositors' and their stockholders'). Just because the banks disappear doesn't mean the lenders will. Borrowers will still want to borrow and lenders will still want to lend. The only question is whether they'll be able to find each other.

That's one reason I feel squeamish about the official pronouncements we've been getting. They tell us bank failures will make it hard to borrow but never that bank failures will make it hard to lend. But every borrower is paired with a lender, so it's odd to state the problem so asymmetrically. This makes me suspect that the official pronouncers have not entirely thought this thing through.

In the 1930s, a wave of bank failures did make it hard for borrowers and lenders to find each other, and the consequences were drastic. But times have changed in at least two relevant ways. First, the disaster of the 1930s was caused not just by bank failures, but by a 30% contraction of the money supply, which is something today's Fed can easily prevent. Second, as any user of match.com can tell you, the technology for finding partners has improved since then. When a firm wants to raise capital, why can't it just sell bonds over the web? Or issue new stock? Or

approach one of the hedge funds that seem to be swimming in cash? Or borrow abroad?

I know, I know, the rest of the world is in crisis too. But surely in the vast global economy, it should be possible to find someone capable of introducing a lender to a borrower. (Note that I'm not talking about going to foreign lenders, though that's another option. I'm just talking about the same American borrower and American lender who would have found each other through Bear Stearns finding each other through Barclays instead.)

In other words, I'm not sure these big Wall Street banks are really necessary, and I'm not sure we'd miss them much if they were gone. Maybe there's something I'm missing, but if so, I think it should be incumbent on Messrs. Bernanke, Paulson and above all Bush to explain what it is.

It's Our Fault, Too

The financial services industry is tanking. Here's what McCain and Obama won't tell you about the crisis.

When John McCain said last week that the "fundamentals of our economy are still strong," he was wrong twice. First, he was wrong to suggest that the annihilation of modern investment banking was something peripheral to economy. Second, when he claimed that "fundamentals" referred to the robust American workforce, he was wrong again to suggest that average Americans somehow represent a fortress of strength against the onslaught of the credit crisis. On the contrary, we've met the enemy, and the enemy is in our own purses and pockets.

Remember the families seeking subprime loans to buy homes way outside their price range? Their defaults started without much fanfare, too petty to be noticed by either bank execs or the media. But like little snowballs rolling from the top of Everest, a smattering of defaults became an overwhelming avalanche of foreclosures and dead-ender mortgages packaged exotically into securities that devastated assets worth billions of dollars. This was largely due to poor regulatory oversight, but as Megan McArdle wrote last week even the dumbest loans are, by definition, mutual, so it seems a bit absurd to exclusively blame Wall Street's investment banks for their clients' defaults. Sure, banks pushed these loans, but foolishly agreeing to borrow money you can't pay back doesn't make you a victim of much except your own imprudence.

But the credit mess doesn't end there. As Michael Mandel pointed out in BusinessWeek, American consumers have overspent and overborrowed by about \$3 trillion in the last ten years. Not to take the investment banking execs off the noose, but spending and lending habits out on Main Street contributed to the infernal scene on Wall Street. McCain's 'fundamentals' are quite fundamental to the credit crisis.

On this issue there is no debate -- literally. John McCain and Barack Obama are leading the bipartisan effort to ignore any public involvement in this fiasco. No surprise. Like the mortgage industry, the market for public policy has structural deficiencies: if hard truths are a commodity, they are subject to the laws of supply and demand. And in this case they are not in demand.

That's why Americans have, for eight years, existed in a world insulated from hard choices. How do you deal with a hundred-billion dollar war, rising health care costs and looming budget crises? Tax cuts, please! And with more quixotic policies coming from both campaigns, this election season is essentially a holiday of promises on the heels of an eight-year holiday from reality. So is it a matter of wasted ink to ask either candidate to address Americans' complicity in the financial crisis?

Maybe. But both candidates have, in recent memory, been known as tellers of hard truths. Straight talk marked the McCain bus like a corporate sponsor, and Obama has followed in Bill Cosby's prickly path to address what he sees as a crisis of personal responsibility in black communities. But could either address personal financial responsibility without coming off like a foul mix of Jim Kramer and scolding parent?

I think it can be done. It would be suicidal to wag fingers at profligate Americans -- after all, you don't want to trash consumer spending. The right message could unite Americans against wasteful spending by calling on them to lead Washington and Wall Street by example. Something like: "Of course, let's hold Wall Street accountable. The executives who put greed above principle, we'll hold them accountable, too. But first, let's hold ourselves to the same standard we expect from our corner-office leaders. We can either lull ourselves into thinking this is the problem of one street in New York or we can learn accountability for our own businesses, financial prudence for our own families, and strategies to keep a thousand Main Streets growing rich responsibly."

This is a risky strategy, inasmuch as any strategy that shops facts instead of promises is generally considered radical. But it's also the kind of honesty that could help either candidate distinguish himself as a fiscally responsible leader who is willing to tell hard truths and, by extension, make the hard decisions required to budget our country through the growing pains of the 21st century.

Consider Barack Obama, whose economic policies lack a unifying theme. He could tell Americans that responsible government starts with responsible citizens, something like: "In an ownership economy, the first step is owning up." After a rough few weeks following the Palin pick, Wall Street's meltdown has been to his advantage. Obama can relax into the financial crisis, fold his fingers and hope world events continue to bend to his benefit. Or, in a year when every week brings another game-changing event, he could recognize that, if this volatile fortnight has taught us anything, it's that there is no such thing as a safe asset.

They've Got Mail

Hackers broke into Sarah Palin's Yahoo email account.

The fact that hackers broke into Sarah Palin's Yahoo email account is, as the McCain campaign says, "a shocking invasion of privacy and a violation of the law." But that sentiment is crocodile tears for a big chunk of the Right (when was the last time it complained about an insufficiently robust commitment to privacy law?), and it's also a distraction. The hacking incident should not draw attention away from the following: Sarah Palin has used her private email account to conduct state business, and she was doing so to circumvent the state's public records law and avoid public scrutiny.

This is a statement of fact, and it has been reported as fact casually and frequently in numerous places well before Palin's account was broken into. It does not and did not depend on whether or not Gawker had the screenshots in hand. On September 10 the *Washington Post* reported that Palin "routinely does government business from a Yahoo address." Last Sunday's *New York Times* reported that "The Governor and her top officials sometimes use personal email accounts for state business," and that "dozens of e-mail messages obtained by The New York Times show that her staff members studied whether that could allow them to circumvent subpoenas seeking public records." Both the *Post* and the *Times* made reference to this exchange:

On Feb. 7, Frank Bailey, a high-level aide, wrote to Ms. Palin's state e-mail address to discuss appointments. Another aide fired back: "Frank, this is not the governor's personal account."

Mr. Bailey responded: "Whoops~!"

This deserves a "Whoops~!" I presume, because the statutes and regulations governing public records are well known and readily available. Specifically, there is Alaska's Title 40, which provides, among other things, that "The chief executive officer of each state agency shall make and preserve public records containing adequate and proper documentation of the organization" (Chapter 21, Section 60), and that, "Unless specifically provided otherwise, the public records of all public agencies are open to inspection by the public under reasonable rules during regular office hours" (Chapter 25, Section 110).

Using private email addresses is an attempt to duck around this law, though I'm not sure it will work. This afternoon I called Dean Dawson, the Alaska State Records Manager, to find out if Palin's Yahoo emails fall under the statute. He said: "They are governed by the statute, if the emails are state-government related and if they constitute record material under 40.21." And since Title 40 also says that a state official who "denies, obstructs, or attempts to obstruct" the public records process "may be enjoined by the superior court" from doing so, maybe someone will sue.

I'm not a lawyer, so I'll have to be content with pointing out all the wonderful hypocrisy here. Last week, when ABC's Charlie Gibson asked Palin about various earmarks Alaska has requested -- including "\$3.2 million for researching the genetics of harbor seals" -- Palin conceded the point but argued that her desire to have those earmarks "in the light of day" was nonetheless important. It was dealmaking that went on "under the public radar" that Palin swore to stop. McCain, likewise, has spent years preaching the gospel of government transparency.

Well, it's hard to think of anything less transparent than conducting state business with the obvious intention of avoiding laws designed to promote state transparency. And in that context it's slightly unctuous to complain about privacy, when the vast majority of privacy laws are designed to protect the people against state coercion. (Think Fourth Amendment rights.) Palin's Alaska seems designed to do the opposite: protect the state against the coercion of the people, otherwise known as democracy.

The Phantom Menace

Why is Barack Obama running against the record of George W. Bush?

Have you heard the Democrats' newest nickname for John McCain? It's "Bush 44," from a speech Joe Biden gave on Monday in Michigan. It's succinct; it's memorable; and it will convince exactly zero people to vote for Barack Obama. The biggest arrow in the Democrats' quiver is cut from an old, wooden meme that asks Americans to transfer their visceral hatred of President George W. Bush onto John McCain. If there's a way to link the Arizona senator to the lame duck president, you better believe the Democrats have thought of it. Voting record? Bush and McCain agree ninety percent of the time. Economic issues? Just "more of the same." Those adoring hugs between McCain and the president? They're the kicker of every Obama ad.

But so much for that. After four months of stagnating and ultimately drooping support for Barack Obama among the anti-Bush independents, it's time to concede that the strategy isn't working. More than half the country considers McCain a legitimate "agent of change," according to a September Gallup poll. In key blocs such as independents and Americans making more than \$75,000, he's tied with Obama within the margin of error.

How can Americans consider McCain an agent of change when Democrats keep reminding them that he's just like President Bush? To amend a line from Obama's convention speech: It's not because Americans don't get it; it's because average American doesn't care.

As Peter Balk wrote in the *New York Times Magazine* last week, America has moved on from the Bush legacy. The surge has taken Iraq casualties off the front page. The Democratic Congress has taken the policy-making off the White House agenda. As a result the president has contributed little to the news cycle besides a quote here and there to express faith in the economy and the Republican Party. When was the last time you saw a prominent liberal bash a new policy from the outgoing president? Bush used to torment the Democratic Party. Now the menace is a phantom.

This is huge blow to Obama, whose basic strategy over the last four months was an elegant syllogism: We'd all vote against Bush; McCain is just like Bush; therefore we should all vote against McCain. But now,

instead of successfully tying McCain to the GOP's biggest liability, Obama has pinned his argument on a guy we've all agreed to forget.

The national conventions tell the whole story. In Denver Democrats referred to George Bush almost 200 times. At the Republican convention, he received one solitary mention. Sure, this was partly a matter of necessity: Republicans weren't about to sing hosannas to a president who's left the party's reputation in tatters. But their selective amnesia also allowed them to focus on the future (albeit a future without many concrete ideas). Obama's fixation on Bush has partly trapped the Illinois senator in a retrospective exercise that McCain can trump by simply ignoring the president. Right now, maybe it's better to do as McCain does, to pretend - or acknowledge - that George W. Bush no longer exists in any meaningful way.

I don't blame Obama for conceiving the McCain-Bush strategy. He's certainly got a point: In an election that everyone agrees is about change, it's a bit strange that the candidate now leading among independents has no significant differences with the outgoing president. But if Obama hopes to win the election, he needs to grab the campaign spotlight and shift it from the space between McCain and Bush to the space between the two John McCains.

The Wall Street meltdown provides a perfect frame for that kind of attack. Instead of focusing on "the same old" fiscal policies, Obama can focus on McCain's shifting stances on the economy: his votes for and against tax cuts; his statements for and against the fundamental strength of the economy; his schizophrenic take on his own understanding of economics. These are unsettling times. If Obama can convince Americans that McCain's understanding of the economy is as shifty as the financial sector, he might be able to win the independents he's bored silly with comparisons to George Bush. Whoever that is.

The Blame Game

As Lehman Brothers melts down, the economy comes up on the campaign trail.

In times of crisis, financial reportage has a tendency to slip into the apocalyptic style of Old-Testament prophecy. "They shall cast their silver in the streets, and their gold shall be removed: their silver and their gold shall not be able to deliver them in the day of the wrath of the LORD: they shall not satisfy their souls, neither fill their bowels: because it is the stumbling block of their iniquity." Ezekiel could have been writing for a major financial paper during any of half a dozen panics over the last two decades. As it happens, I was doing technology work on a trading floor during the Asian meltdown in 1998, and I heard a young trader ask a grizzled veteran whether this was the worst crisis ever. The older man shrugged.

"They're all the worst ones when they're happening."

This insight has calmed me through several subsequent panics. But when an op-ed in this morning's *New York Times* called the possibility of an AIG liquidation "as close to an extinction-level event as the financial markets have seen since the Great Depression," it wasn't hyperbole; it was a statement of fact. The world's largest insurer has its tendrils planted in every corner of the financial world, including insuring the remaining solvent financial institutions against defaulting mortgage bonds. A failure would send those institutions scrambling for new cover, while dumping billions of dollars of assets into already depressed markets. This, in turn, would weaken balance sheets, possibly pushing other institutions along the footsteps of Lehman and Merrill Lynch.

Naturally, the two presidential candidates are moving quickly to deal with this crisis -- that is, to blame it on everyone except themselves. John McCain and his surrogates are pushing the dubious notion that the primary problem is a lack of transparency and accountability. He might send someone down to Lehman's trading floor to ask the people packing up their desks whether they feel they've gotten away with something.

Meanwhile, Barack Obama is pointing the finger at John McCain, or at least Senator McCain's ideas:

The challenges facing our financial system today are more evidence that too many folks in Washington and on Wall Street weren't minding the store. Eight years of policies that have

shredded consumer protections, loosened oversight and regulation, and encouraged outsized bonuses to CEOs while ignoring middle-class Americans have brought us to the most serious financial crisis since the Great Depression.

I certainly don't fault Senator McCain for these problems, but I do fault the economic philosophy he subscribes to.

This may play well on television, but it is rather disappointing coming from the man who promised us a new kind of politics. There have been no significant changes to the financial regulations in the last eight years that might credibly have created this crisis (the one major alteration, Sarbanes-Oxley, moved things in the other direction). And it's hard to blame loosened oversight when the entire market systematically overvalued the now-toxic securities. Lehman Brothers was not, after all, trying to put itself into receivership for the sheer joy of molesting taxpayers. The SEC is an extremely valuable agency, but even its crack regulators are not omniscient demigods who can instantly divine the "true" price of a complex security. Nor does it make sense to blame overpaid CEOs. Rick Wagoner's millions may be ill-deserved, but they did not force his customers to take out unreasonably large bank loans, nor compel investment managers to buy the securities into which those loans were packaged.

But both candidates are right about one thing: America's financial regulatory structure is badly outdated, and in need of a massive overhaul. Its overlapping agencies seem to work at cross-purposes as often as they cooperate, and the fuzzy lines of authority can exacerbate panic because of a lack of any clear procedure for wrapping up big insolvencies. And its inertia in the face of changing markets has left it ill-prepared to deal with the current crisis. The SEC, for example, continued the process of forcing securities issuers to use a few government-sanctioned ratings agencies to certify their securities, despite mounting evidence that this cozy oligopoly was falling down on the job. As with most regulations, the quality floor quickly became a ceiling, as issuers did just enough to get approval.

More broadly, all of the regulatory bodies failed to realize, or react to, the fact that an increasingly complex array of financial instruments had introduced new risks into the financial system. It is far from clear that these risks should have been avoided by banning the more exotic derivative structures, as some commentators have urged. But the risks should have been known.

America's entire approach to regulation is a relic of the New Deal, when optimistic Keynesians still believed that they might tame the economy by getting bright technocrats to run it. Seventy-five years later, we know that an economy of 300 million people is too complex to be controlled by any institutions, no matter how well-intentioned or well-managed. But our regulatory bodies still function on the dream that we can find bright public servants to wring all of the risk out of the system by carefully inspecting each product and certifying its quality.

A better approach would be to focus less on eliminating risk, and more on managing it. This means not only greater transparency, but encouraging alternate ratings systems to help make investors aware of risk. It also means developing procedures to cope with the inevitable failures, rather than scrambling to put together ad-hoc solutions when the market, shockingly, once again fails to behave.

But it is probable that instead of better regulation, we will simply get more of it. Regulatory institutions are hard to replace; over time they develop strong constituencies in both their employees and the institutions they regulate -- institutions that would rather deal with the devil they know, especially since the devil they know often functions as a barrier to entry for newer, smaller firms that might grow into real competition. Real reform -- in the original sense of remaking the institutions into a *better* form -- seems unlikely. Rather more certain is that down the road, some other financial crisis will take the beefed up bodies by surprise.

The Fatal Cure

David Foster Wallace, a postmodern writer and Atlantic contributor, hanged himself Friday.

Kurt Vonnegut, a novelist who practically begged to be put on suicide watch, thought that writing novels was a treatment for depression, if not an outright cure. Blues music, he suggested, was analogous: a way of palliating an intolerable condition by transmuting it into art. A clinical study at the University of Iowa supported the theory that depression runs in the families of writers, and a wide array of anecdotal evidence (I would cite the film *Crumb*) suggests that practicing an art can, if the artist is lucky, save him from the fate of his relatives.

Vonnegut somehow made it to life's finish line without taking a shortcut, whereas Wallace, sadly, did not. That Wallace's depression remained relatively hidden in his writing will make his most comic material all the gloomier in retrospect. The figure of James Incandenza, the suicidal father in *Infinite Jest*, might bear new scrutiny: in performances of *Hamlet* -- a play that pervades *Infinite Jest*, starting with the title -- Shakespeare played the role of Hamlet's dead father, and I wonder whether the same affinity existed between Wallace and James Incandenza. Their respective chefs d'oeuvre certainly have a great deal in common, again starting with the title, and continuing, I'm afraid, through their gleefully jejune content.

I wonder whether we can decently consider Wallace's death a sign that the postmodern novel fails as a psychiatric remedy, where the merely comic novel does not. (In Wallace's case, traditional treatments -- drugs, shock therapy, hospitalization -- had already gotten nowhere.) In Vonnegut's work I detect signs that the author was surveying the planet, and finding enough pity and bathos to sustain a life worth living. Wallace's fiction, by contrast, instantiates the same meaningless trends that are his subject, and to unclear effect. The humor reaches such a crescendo of introspection and self-questioning that it ends up as its own best critic. That critic is a keen one indeed -- so devastating that Wallace himself convinces me that his novels, in the end, are mostly exhibitions of style.

I count that as a failure, and I think Wallace did too. Is it coincidence that Wallace idolized William T. Vollmann, surely the most earnest writer of his generation? Wallace's first novel, the strange and

unwonderful *Broom of the System*, was a novelization of Wittgenstein's *Tractatus Logico-Philosophicus* -- a work that argued that most philosophy was meaningless. His later fiction seems to concur. It's melancholy to reflect that this postmodern sensibility could render writers even more defenseless in their solitary and terrestrial hell than they already are.

In Defense Of Elitism

Gov. Sarah Palin continues to emphasize her credentials as "just your average hockey mom."

Like most members in good standing of the Washington media elite, I have naturally and inevitably grown to hate Sarah Palin. But that's okay, because the feeling is evidently mutual. At last week's convention, Palin went on about how "experts in Washington" were counting out McCain with their "usual certitude" and the "Washington elite" weren't taking her seriously because she isn't part of the club. Palin, you see, is a typical American -- a hockey mom who has "had the privilege of living most of [her] life in a small town," as part of a family that has "the same ups and downs as any other." "I also drive myself to work," she added, just in case we didn't get the point.

The aw-shucks act serves two purposes. First, claiming to be The Average is a useful mallet for beating down criticism as hopelessly snobbish -- as when Bill Kristol writes in this week's Weekly Standard that "the liberal elites" will appeal to their "anti-small town" prejudices when they try, presumably with their usual certitude, to keep Palin 3400 miles away from Washington. (I have no idea what "anti-small town" prejudices look like, but I guess I better get some.)

Second, and more importantly, Palin's everyday qualities are supposed to be an actual electoral and governmental asset -- as when Kristol writes (this time in the Times) that by picking a real-live "Wal-Mart Mom," John McCain might have a decisive number of voters saying, "It's about time." Reverse snobbery is the new snobbery: the way to win an election and govern a country is by seeming as ordinary as the limits of credulity allow.

Let me take the bait and make a plea for good old-fashioned elitism: It's not "about time" for an average American to occupy the White House (or the Naval Observatory), and the notion that some ossified and preening elite lords over Washington is silly.

Everyone is an elitist. We want elite doctors to treat our cuts and cancers. We want elite lawyers and accountants to smooth over our divorces and taxes. And we (some of us, anyway) want our elite soldiers to invade foreign countries. And we don't apologize for these preferences. In most contexts, "elite" is just another word for "merit."

So why don't many of us want elite politicians? The reverse snobs usually argue that Everywoman politicians are better at understanding everyone's problems. But even if this claim is true (and I'm pretty sure it isn't) it remains suspiciously unextended to all other aspects of social life. We don't think the lawyers who have been dragged through a messy divorce are more capable of handling a client's. Why?

And anyway, anti-elitism strikes me a strange pose for a through-and-through conservative. The helpful oversimplification is that conservatives are supposed to favor equality of opportunity ("everyone competes on equal footing, outcomes be damned") and liberals supposed to favor equality of outcome ("everyone deserves something, competition be damned"). Equality of opportunity is supposed to dictate that race, gender, geography, and nepotism count for nothing - they're all features that have nothing to do with merit. This principle is why the same Bill Kristol could write (about a different unqualified applicant, Harriet Miers) that there was "a gaping disproportion between the stakes associated with this vacancy and the stature of the person nominated to fill it." That she was a Bush loyalist and a woman said nothing about her merits. Palin's interest in hockey and commuting says equally little.

"Merit" might be tough to define and harder to locate -- as a member of the liberal elite, I certainly have some problems with it -- but as a theory, it hangs together coherently. Conservatives used to like it. But I guess all that flew out the window somewhere between Wasilla and Anchorage, maybe while Sarah Palin was driving herself to work.



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