



"Without fear and without favour"

Friday October 8 2010

Farewell to Tarp, a despised policy

Rescue worked better than expected and cost much less

The US Treasury's troubled asset relief programme expired this week, unloved and unremembered. As the midterm elections approach, the legislators who voted for it – as most did – prefer not to mention the fact. In the minds of the public, Tarp spent hundreds of billions of dollars with no effect but to line the pockets of reckless, unrepentant banks. The anger it aroused fuels the anti-incumbent, anti-Washington frenzy gripping the country.

Which is interesting, when you consider what a success this bipartisan initiative was, and how little it will end up costing. The Bush administration first put Tarp together. Republicans and Democrats alike supported it. The programme morphed a few times before Barack Obama's team took it over. From start to finish, it was a mess; it was never properly explained to the public; it was hammered by critics at every stage. And it worked quite well.

The first price tag was \$700bn, a figure that stunned the country. It was meant to. This was shock and awe, to demonstrate resolve. But voters were appalled that so much money would go to rescue the institutions that caused the crisis in the first place. Politically, the scale of the intervention was a (perhaps unavoidable) disaster.

Nobody was interested in assurances that the final cost would be much smaller.

And so it proved. The initial estimate was \$300bn, not \$700bn. Then the Congressional Budget Office lowered it to \$66bn. The latest figure is \$29bn – not much, set against a budget deficit of well over \$1,000bn. The banks recovered; the financial system, though impaired, continued to function; the value of distressed assets improved. The scheme would have been cheap at 10 times the price.

Mistakes were made, to be sure. The first three-page version of the proposal, cobbled together in evident panic, was a confidence-destroying calamity. The plan that gradually took shape was too kind to the banks; the terms should have been tougher, and the balance of threats and rewards more tilted to the former. Retaining outright nationalisation as a serious alternative would have been wise. So would discouraging early exit from the scheme and its oversight requirements – notably, on pay.

But lamentable presentation was the most consequential failure. Regulatory reform, if diligently implemented, may lessen the risk of a similar crisis in future. It cannot eliminate it. This time, Tarp worked. Next time, it will not be an option if the public has its way.

A moving target

Regulating pay is important but achieves little on its own

Regulating bankers is a Sisyphean task. No one doubts the hard work of the European regulators who met this week to hammer out rules on bonuses, amid fears that banks could decamp altogether in the face of restraints. But regulators' efforts on pay are not enough.

They have excellent reasons to want to change banks' compensation practices. Incentives to put other people's money at risk facilitated the glutty for leverage that made the crisis possible. Money lost in those risks had to be replenished by taxpayers, making the sight of big bonus rounds politically explosive. With banks still in effect insured by states, high pay reflects a continued heavy burden on the public.

So the common understanding that world leaders have reached on compensation is useful. Tying pay more tightly to the longer-term fortunes of banks by requiring a proportion of bonuses to be deferred and having a larger share take the form of equity, is unobjectionable. But the latest talks, intended to pin down the detailed application of these principles to EU institutions, reveal how difficult it will be to make the rules stick.

One proposal was a ceiling on the share of bonuses that can be paid out in cash in addition to the minimum share that must be

deferred. Another was to cap the size of the bonus as a multiple of salary. The likely effect of either would be that bonuses shrink and salaries grow correspondingly. This would do nothing to reduce the opulence of bankers but would, perversely, insulate them even more from the risk they impose on the rest of us. Even if one pursued the more rational route of targeting overall pay levels rather than just the bonus component, there is no shortage of ways to mask compensation costs as something else.

So long as banking generates profits far above its social productivity, that excess will find its way to bankers' pockets. No regulation of pay can solve this deep difficulty on its own; what is needed is to change the reality that creates economic rent in the first place.

That is extraordinarily hard. It means reforming the banking system's structure or taxing it more. For the latter option, the UK's levy on bank liabilities and the tax on pay and profits endorsed by the European Commission are sensible approaches – but ones that no jurisdiction can pursue alone on a scale that makes a difference.

Agreeing on pay rules is a start. For banking reform to be effective, however, we need agreement on how to cure the disease as well as treat the symptoms.

Pricing pensions

UK public sector staff will have to work longer, pay more

It has turned out to be good policy as well as good politics. In June, when the Con-Lib coalition asked John Hutton, a former Labour minister, to carry out an independent review of public sector pensions, it might have been no more than a "big tent" gimmick to provide cover for unpopular cuts. But the interim Hutton report published on Thursday deserves a welcome as a thoughtful and substantial approach to one of the thorniest issues facing the government.

The analysis is compelling. The current balance of risks and costs between public sector staff and employers cannot be sustained. Longevity and the employment landscape have changed significantly since most schemes were devised. The arrangements get in the way of public sector efficiency and innovation because they are a barrier to private providers.

The report sets boundaries for reform in the right places. Accrued rights cannot be cut back because a pension is deferred pay. The public sector should not seek to copy the markedly less generous provision in the private sector. To do so would leave future taxpayers picking up a larger bill to support people who had not saved enough for their retirement: about 85 per cent of public sector employees are in some form of employer-sponsored

pension, against just 35 per cent in the private sector.

Within these limits, the obvious source of short-term savings is raising higher employee contribution rates. Each 1 per cent increase should yield about £1bn. Given the public sector pay freeze, this would amount to a pay cut. It is still the right answer, though it may require staging to make it more palatable.

The report points towards a longer-term change from the final salary scheme which rewards high-fliers disproportionately. A hybrid scheme, which combined benefits based on a career-average salary with a further element in which the employee took more risks through defined contributions would be complex – but fairer and more affordable.

An integral part of reform should be higher retirement ages for existing public sector workers as well as recruits. Failure to act would mean that the next generation, who will anyway have to retire later than those currently employed, has to work even longer to pay for the generous terms enjoyed now. That would be unfair. Yet this was where the last Labour government buckled in the face of union ferocity. This government should show it is made of sterner stuff.

Letters

Missed opportunity to tackle chronic surpluses

From Mr Daniel J. Aronoff.

Sir, Martin Wolf makes a reasoned and utterly persuasive case for taking action to neutralise the destabilising effects of China's mercantilist exchange control and sterilisation policies ("How to fight the currency wars with a stubborn China", Comment, October 6). I would like to add a few observations.

First, the demand leakage that accompanies a large trade deficit dissipates the domestic impact of fiscal stimulus, which strengthens the case against further US fiscal loosening.

Second, the massive scale of Chinese capital exports into the US over the past decade artificially depressed interest rates, while the accompanying US trade deficit made possible a simultaneous increase in US consumption and investment, the combination of which fuelled the asset price and investment bubble.

When the US Federal Reserve attempted to slow the expansion by increasing its policy rate in 2005, it was unable to affect long-term rates – Alan Greenspan famously phrased it a "conundrum" – because the wave of offshore capital inflows had become the dominant influence on US interest rates.

In the absence of the imbalances in the current and capital accounts, US interest rates would, by mid-decade, have likely risen in response to the increase in investment and consumption and choked off the bubble at a much earlier stage. This means the myopic focus on banking reform to prevent future destabilising bubbles is partially misplaced.

There should also be recognition that capital inflows undermined the natural brakes on investment that would have operated in the absence of the trade imbalance.

Third, a prerequisite for a sustainable increase in US savings, after the current crisis has passed, is that US interest rates reflect the "societal" discount rate and are not forced artificially below this "natural" rate by state action, since artificially low interest rates boost asset valuations while reducing investment returns, which discourage savings.

Finally, I cannot resist pointing out that Keynes had this all figured out 65 years ago at Bretton Woods, and the irony that it was the US – then the world's leading exporter – who sandbagged his proposal to the International Monetary Fund with the authority to take action against countries that ran chronic surpluses.

Daniel J. Aronoff,
President and Chief Executive,
The Landon Companies,
Bloomfield Hills, MI, US

Excessive debt is a high-risk move

From Mr Paul Claydon.

Sir, Martin Wolf ("The IMF's foolish praise for austerity", Comment, October 1) asks why it would be wise to bequeath a smaller economy to posterity instead of higher debt. The best legacies are solid, stable, high quality assets that give security to future generations. When the smaller economy option already comes with excessive debt, then the sensible answer to Mr Wolf's question seems obvious.

Recent times have reminded us all that excessive debt is the cause of most financial problems. Mr Wolf's stance is that the UK could benefit from even higher debt. Surely he would acknowledge that this comes with higher risk? If the higher debt option were to go wrong, what would be the UK's contingency plan?

Paul Claydon,
Havant, Hants, UK

Where will drive for austerity lead?

From Mr David Boorer.

Sir, Martin Wolf (October 1) says that the wish for a more austere approach to our economic problems is poverty of ambition.

How do we know (given the record of economics in pointing the way forward from now, let alone for guiding us so far into the current situation) that such an approach is not a wealth of common sense instead?

I do not know whether he is right or wrong. But, given that there are equally (or more?) convincing arguments that say we should, for example, allow our asset prices and our expectations to be lowered to reflect the west's loss of economic power to the emerging – or rather emerged – economic powers, perhaps austerity is a necessary preliminary to building a secure foundation for the future.

I am not asking what you think, Mr Wolf, but how do you "know"?

David Boorer,
Hexham, Northumberland, UK

What the banks aren't telling us

From Lord Myners.

Sir, Lex ("Kerviel verdict", October 6) asks what would have happened if Jérôme Kerviel had stopped while ahead.

Why do banks announce only losses, and never profits, as a result of "unauthorised trading"?

Paul Myners,
UK House of Lords

Corrections

● Due to a transcription error, an article in the FT on October 6 identified Liu Xiaoming as China's ambassador to South Africa. Mr Liu is the country's ambassador to the UK. Zhong Jianhua is China's ambassador to South Africa.

● Toshihide Iguchi, the rogue trader, worked for Daiwa Bank, not Daiwa Securities as wrongly stated in an article on October 6.

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Infrastructure can help build a legacy

From Mr Richard G. Little.

Sir, George Soros makes an excellent argument for investing in infrastructure as opposed to just increasing public spending ("What America needs is stimulus, not virtue", Comment, October 5). However, the current administration has not made a compelling case to the American people for why infrastructure matters, both in the short and long term.

These massive investments are about more than just jobs today; they must support vibrant and sustainable economic growth for the future. The New Deal put in place a set of infrastructures that, as Mr Soros notes, we still benefit from today. We need to take care that we borrow to build systems of similar lasting value.

Future generations should be able to look back and note the wisdom of their forebears in investing in the transformational technologies that not only put people back to work but smoothed the way for the US to remain competitive in a 21st (as opposed to a 20th) century economy.

Richard G. Little,
Director,
Keston Institute for Public Finance and Infrastructure Policy,
University of Southern California,
Los Angeles, CA, US

From Mr Ralph Musgrave.

Sir, George Soros's article "What America needs is stimulus, not virtue" (October 5) is spot on, bar one error. He assumes that deficits necessarily result in extra national debt, and worries about this.

As Milton Friedman made clear in a paper in the American Economic Review, one can perfectly well have a monetary system that involves no national debt at all, and still regulate demand. (Incidentally Samuel Brittan referred approvingly to this Friedman paper in his September 24 column "Guzzle for the sake of the world economy".)

Ralph Musgrave,
Durham, UK

Known for optimism about Latin America's prospects

From Mr George de Lama.

Sir, We read with great interest the story in the Financial Times about Brazil ("Great expectations", Analysis, September 29). Unfortunately, we were disappointed that you quoted Luis Alberto Moreno, president of the Inter-American Development Bank, out of context. As a result, your readers were left with a misleading impression of his remarks and his views on the subject.

Mr Moreno was referring to Latin



Why endure more London cram ...



... when there's space on a Zurich tram?

London is a less attractive place to live

From Mr Alessandro Ciravegna.

Sir, Your coverage of hedge fund managers and traders leaving London for Switzerland fails to recognise the intensely personal decision that moving a family involves ("Hedge fund shift costs UK £500m", October 2).

As you suggest, the catalyst that has led to the exodus from London may well have been the combination of higher taxes and regulatory uncertainty but what will increasingly tip the scales in favour of relocating for those who can is London's quality of life.

If you consider three basic elements of life for a family in a city – housing, transport and education – London does not score highly. A family house in London can cost £2,000 a square foot merely because of location. The unreliability of the transport system can dominate how a family plan their daily lives, from where they live to where they send their children to school. On the assumption that hedge fund managers and traders are likely to educate their children at private schools, the fall in educational standards and exam grade inflation has left many children with grades of increasingly dubious educational

value and at an after-tax cost that is considered inconceivable by anyone outside the UK or the US.

My critics will point out that only London has a peerless collection of cultural activities but in most cases are not honest enough to admit when they last went to the National Gallery or the British Library.

By comparison, Switzerland, while hardly inexpensive, offers a wider choice of acceptable housing. Its superb transport infrastructure not only makes it possible to live outside central Zurich or Geneva, but allows families to decide how to spend their free time without being constrained by the time, difficulty and expense of getting to where they want to be. Swiss state schools provide a high, multilingual, standard of education in an environment where children from different backgrounds are able to be taught in the same classroom.

The risk to London and the UK's economy is not merely from tax and the regulatory environment but also from the failure to recognise that London has become a less attractive place in which to live.

Alessandro Ciravegna,
New College Capital,
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More comment online

Why cricket affects India's markets

Beyond Brics (Amy Kazmin): Indians are fanatical about cricket: a game against Australia or Pakistan brings the country to a halt, as millions abandon daily duties and tune in instead. But India's performance in one-day cricket internationals also turns out to have a strong spillover effect in an unexpected area – the stock market.

In an upcoming article in the Pacific-Basin Finance Journal, Professors Russell Smyth and Vinod Mishra have found that India's stock market tends to tumble if the Indian team loses. The country's main stock index dropped by an average of 0.231 per cent the day after an Indian loss. That's a measurable impact more than seven times the impact of a win for India; the researchers found the latter had no statistically significant effect on share prices.

The researchers also found that the average drop following a loss was 18 per cent higher if the game came when Sachin Tendulkar (pictured), known as the "master blaster" for his batting acumen, was not playing.

"Behavioural finance suggests that large sporting events affect the sentiment of viewers-cum-investors, resulting in upward or

downwards 'mood swings' in the market, which are reflected in stock prices." Prof Smyth, head of the economics department at Australia's Monash University, explained.

He added that a loss could prompt sorrow, meaning that trading volumes fall as fans withdraw from the market temporarily, or anger, which could trigger impulsive selling.

Prof Smyth said: "When you are tuning in to follow how Australia performs against India in one-day internationals, before you write them off as meaningless matches, spare a thought for what the outcome might mean for Indian investors."

As the Bombay Sensex approaches a record high, the question is whether traders will still be subject to the same sporting mood swings.

www.ft.com/beyondbrics



Is quiet the new loud?

Clive Crook's Blog: I recommend the new movie by Bjorn Lomborg and documentary filmmaker Ondi Timoner, *Cool It*, based loosely on Lomborg's book of the same title. It is a reply to Al Gore's *An Inconvenient Truth*, and much better (effective though Gore's movie was as propaganda). I went to a

screening of the nearly final version at the Heritage Foundation on Wednesday. It is well done. Not just watchable but absorbing all the way through, and extremely persuasive.

Lomborg was recently – and fatuously – accused by The Guardian of doing a U-turn on this subject. His position all the way through has been that climate change is happening and that it is largely man-made. He has also argued, to the consternation of many greens, that Kyoto-like policies are both expensive and ineffective. He is right on both points, in my view.

The film restates this critique but quickly moves on to look at more productive post-Copenhagen approaches: pursuing new technologies to make low-carbon energy cheap, geoengineering and adaptation.

Instead of spending hundreds of billions of dollars on policies that won't work, Lomborg argues for smaller (though still substantial) sums to be spent on R&D directed at new energy technologies, leaving a surplus for relieving malnutrition and disease in developing countries. This sounds like a heavy agenda for an evening at the movies, but it's artfully done. Interviews with the likes of Nathan Myhrvold and Freeman Dyson are nicely mixed in; the animations and graphics are as good as in Gore's movie (which is high praise); there are jokes. The whole thing moves along really well.

The tone of the movie is calm, intelligent and engaging. Lomborg bemusedly said that at the Toronto

Film Festival, one of the movie critics who came along to the screening asked him afterwards, "Is quiet the new loud?" If only.

Full text: www.ft.com/crookblog

Currency dilemma

FT Alphaville (Cardiff Garcia): The US has expressed disappointment that the renminbi has hardly budged since June, when China promised it would allow more flexibility in the exchange rate. And the US can observe other emerging markets have appreciated substantially against the dollar since late 2008.

Contrast that with the Chinese view, which relies on looking at exchange rates vis-à-vis their historical levels rather than the rate of appreciation in the last couple of years. Ashmore summarises (emphasis ours): "China's non-gold reserves stand at \$2,454bn. This has caused repeated animosities but in itself may not be a problem if domestic prices and wages are allowed to adjust. However, though China intervened massively, its exchange rate appreciated faster than its competitors and since the Lehman Brothers' collapse the renminbi has remained among the most appreciated currencies against the dollar."

So China is worried that an overly rushed appreciation will lead to big losses for its exporters and loss of market share to other emerging economies, whose currencies remain relatively depreciated against the dollar.

Full text: www.ft.com/alphaville

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