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Reform or Bust

by Paul Krugman

In the grim period that followed Lehman's failure, it seemed inconceivable that bankers would, just a few months later, be going right back to the practices that brought the world's financial system to the edge of collapse. At the very least, one might have thought, they would show some restraint for fear of creating a public backlash.

But now that we've stepped back a few paces from the brink - thanks, let's not forget, to immense, taxpayer-financed rescue packages - the financial sector is rapidly returning to business as usual. Even as the rest of the nation continues to suffer from rising unemployment and severe hardship, Wall Street paychecks are heading back to pre-crisis levels. And the industry is deploying its political clout to block even the most minimal reforms.

The good news is that senior officials in the Obama administration and at the Federal Reserve seem to be losing patience with the industry's selfishness. The bad news is that it's not clear whether President Obama himself is ready, even now, to take on the bankers.

Credit where credit is due: I was delighted when Lawrence Summers, the administration's ranking economist, lashed out at the campaign the U.S. Chamber of Commerce, in cooperation with financial-industry lobbyists, is running against the proposed creation of an agency to protect consumers against financial abuses, such as loans whose terms they don't understand. The chamber's ads, declared Mr. Summers, are "the financial-regulatory equivalent of the death-panel ads that are being run with respect to health care."

Yet protecting consumers from financial abuse should be only the beginning of reform. If we really want to stop Wall Street from creating another bubble, followed by another bust, we need to change the industry's incentives - which means, in particular, changing the way bankers are paid.

What's wrong with financial-industry compensation? In a nutshell, bank executives are lavishly rewarded if they deliver big short-term profits - but aren't correspondingly punished if they later suffer even bigger losses. This encourages excessive risk-taking: some of the men most responsible for the current crisis walked away immensely rich from the bonuses they earned in the good years, even though the high-risk strategies that led to those bonuses eventually decimated their companies, taking down a large part of the financial system in the process.

The Federal Reserve, now awakened from its Greenspan-era slumber, understands this problem - and proposes doing something about it. According to recent reports, the Fed's board is considering imposing new rules on financial-firm compensation, requiring that banks "claw back" bonuses in the face of losses and link pay to long-term rather than short-term performance. The Fed argues that it has the authority to do this as part of its general

mandate to oversee banks' soundness.

But the industry - supported by nearly all Republicans and some Democrats - will fight bitterly against these changes. And while the administration will support some kind of compensation reform, it's not clear whether it will fully support the Fed's efforts.

I was startled last week when Mr. Obama, in an interview with Bloomberg News, questioned the case for limiting financial-sector pay: "Why is it," he asked, "that we're going to cap executive compensation for Wall Street bankers but not Silicon Valley entrepreneurs or N.F.L. football players?"

That's an astonishing remark - and not just because the National Football League does, in fact, have pay caps. Tech firms don't crash the whole world's operating system when they go bankrupt; quarterbacks who make too many risky passes don't have to be rescued with hundred-billion-dollar bailouts. Banking is a special case - and the president is surely smart enough to know that.

All I can think is that this was another example of something we've seen before: Mr. Obama's visceral reluctance to engage in anything that resembles populist rhetoric. And that's something he needs to get over.

It's not just that taking a populist stance on bankers' pay is good politics - although it is: the administration has suffered more than it seems to realize from the perception that it's giving taxpayers' hard-earned money away to Wall Street, and it should welcome the chance to portray the G.O.P. as the party of obscene bonuses.

Equally important, in this case populism is good economics. Indeed, you can make the case that reforming bankers' compensation is the single best thing we can do to prevent another financial crisis a few years down the road.

It's time for the president to realize that sometimes populism, especially populism that makes bankers angry, is exactly what the economy needs.

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Paul Krugman is professor of Economics and International Affairs at Princeton University and a regular columnist for The New York Times. Krugman was the 2008 recipient of the Nobel Prize in Economics. He is the author of numerous books, including The Conscience of A Liberal , and his most recent, The Return of Depression Economics .

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