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The Conscience of a Liberal

Paul Krugman



April 23, 2010, 5:51 pm

Pesos, Ponzi, And Financial Sector Profits

There's been an interesting exchange over [my suggestion](#) — which is by no means original — that the stability of banks between 1935 and 1980 or so had a lot to do with lack of competition, which gave banks a franchise value that executives didn't want to endanger with risky strategies.

[Mike Konczal](#) raises a good point: how do we reconcile loss of franchise value with huge financial-sector profits? And [Ryan Avent](#) offers a possible answer: soaring leverage. I've been thinking along the same lines, with a bit of a twist.

Here's how I come at the issue: basically, the financial industry has been borrowing vast sums at low interest rates, and investing the funds in higher-yielding assets. But why do those assets yield more? Largely, I'd argue, because of the "peso problem" — a term that came out of the MIT graduate student lunchroom in the mid-70s, with nobody quite sure who invented it.

The observation that started it all was the fact that back then Mexico had a fixed exchange rate against the dollar, but Mexican bonds consistently yielded several percentage points more than US bonds. Why? Presumably because there was a significant perceived probability of devaluation. Yet no statistical test would have shown this, because it was a low-probability event that hadn't happened yet. Instead, crunching the numbers would have shown a clear gain from borrowing in dollars and lending in pesos.

That, I'd argue, is what the financial industry has been doing for a long time: borrowing by issuing supposedly safe assets, investing the proceeds in assets that don't really yield more, but seem to.

But why are they able to borrow so cheaply? Here I think [Gennaoli, Shleifer, and Vishny](#) (pdf) have the right idea: financial innovation has created assets — largely asset-backed securities — that for a long time were falsely perceived as safe, and priced accordingly.

The one thing I think their paper doesn't get at is that the low-probability event that revealed the falsity of these perceptions wasn't exogenous. What has happened instead was that the very growth of the financial sector led to an upward trend in asset prices that masked the real risks — the way the housing bubble masked the true risks of subprime lending is a key example, but not unique. Sooner or later, however, the bubble would run out of room to expand, and the whole thing would collapse.

If this sounds Ponzi-ish, it should. Bob Shiller pointed out way back in his book "Irrational Exuberance" that a bubble is, in effect, a natural Ponzi scheme, which doesn't actually require a deliberate act of fraud yet has the same effect.

So I'd suggest that what we did between 1980 and 2008 was to replace a financial system in which profits were created by lack of competition with a system in which profits were created by misinformation and misperceptions — a giant, if mostly (not entirely) unintentional Ponzi scheme, which finally went bust.

And without strong reform, it will happen again.

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Paul Krugman is an Op-Ed columnist for The New York Times.

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Books

- ⌄ [Principles of Economics, 2nd ed.](#) (2009)
- ⌄ [The Return of Depression Economics and the Crisis of 2008](#) (Dec. 2008)
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