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Secondary Sources: Raw Deal?, Root Problems, Krugman

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A roundup of economic news from around the Web.

- **Raw Deal:** Writing for the Guardian, **Joseph Stiglitz** says that U.S. taxpayers got a raw deal in the Paulson plan. "There is no comparison with the terms that Warren Buffett secured when he provided capital to Goldman Sachs. Buffett got a warrant - the right to buy in the future at a price that was even below the depressed price at the time. Paulson got for the US a warrant to buy in the future - at whatever the prevailing price at the time. The whole point of the warrant is so we participate in some of the upside, as the economy recovers from the crisis, and as the financial system starts to work. The Paulson plan responded to Congress's demand to have something like a warrant, but as a matter of form, not substance. Buffett got warrants equal to 100% of the value of what he put in. America's taxpayers got just 15%. Moreover, as George Soros has pointed out, in a few years time, when the economy is recovered, the banks shouldn't need to turn to the government for capital. The government should have issued convertible shares that gave the right to the government to automatically share in the gain in share price." The sentiment is echoed by Duke's **Campbell Harvey** on the university's Research Advantage blog, where he suggests an alternative. "Here is a different approach to equity injection: Mandatory investment in financial institutions (which solves the stigma problem). The amount of equity should be small and passive. No investment in financial firms below the margin – relegate them to a new RTC like entity. Five to seven year term holding period and then government liquidates their stake. The fund gets all the upside for their investment (not just 15%). Essentially, the government is running a giant hedge fund with two differences. First, the principals of the fund have 'inside' information from FDIC on the health of the banks they are investing in (and, hence, can avoid bad bets). Second, we know that the government will take other actions, fiscal and/or monetary to make sure the investment pays off."
- **Root of the Crisis:** **Kenneth Arrow**, writing for the Guardian, says that the core problem was not understanding the consequences of spreading risk. "There is obviously much more to the full understanding of the current financial crisis, but the root is this conflict between the genuine social value of increased variety and spread of risk-bearing securities and the limits imposed by the growing difficulty of understanding the underlying risks imposed by growing complexity." Meanwhile, writing for the Financial Times, **Edward Chancellor** talks about the role of panic. "Bank panics always have the same origin. "Every genuine business panic springs from the same root, which is rank speculation," wrote one Victorian commentator. Thomas Tooke, the early 19th century merchant and author, ascribed the British crisis of 1793 to "a great and undue extension of the system of credit and paper circulation". A year earlier, Thomas Jefferson, observing the first financial collapse in the independent United States, noted that "our paper bubble has burst"."
- **Krugman's Work:** On his blog, **Paul Krugman** explains the work that won him the economics Nobel. "France and Germany sell lots of stuff to each other, even though they have similar climates and resources; so do the United States and Canada. What's that about? The answer is that there are many goods that aren't like wheat or bananas, but are instead like wide-bodied jet aircraft. There are only a few places in which wide-bodied jets are produced, because of the enormous economies of scale – you only want a couple of factories worldwide. Those factories have to be somewhere, and those countries that get the factories export jets, while everyone else imports them. But who gets the aircraft factories, or the factory producing a specialized kind of machine tool, or the plant producing a particular model of car that selected consumers all over the world want? The answer of new trade theory – and it was a tremendously liberating answer – is that it doesn't matter. There are many economies-of-scale goods; everyone gets some of them; and the details, which may be largely a story of historical accident, aren't important."

Compiled by Phil Izzo