

- ε [Get Home Delivery](#)
- ε [Log In](#)
- ε [Register Now](#)

- ε [Home Page](#)
- ε [Today's Paper](#)
- ε [Video](#)
- ε [Most Popular](#)
- ε [Times Topics](#)

Search All NYTimes.com

The New York Times

Monday, May 6, 2013

Opinion

- ε [World](#)
- ε [U.S.](#)
- ε [N.Y. / Region](#)
- ε [Business](#)
- ε [Technology](#)
- ε [Science](#)
- ε [Health](#)
- ε [Sports](#)
- ε [Opinion](#)
- ε [Arts](#)
- ε [Style](#)
- ε [Travel](#)
- ε [Jobs](#)
- ε [Real Estate](#)
- ε [Autos](#)

- ε [Editorials](#)
- ε [Columnists](#)
- ε [Contributors](#)
- ε [Letters](#)
- ε [The Public Editor](#)
- ε [Global Opinion](#)

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.

- ε [E-mail This](#)
- ε [Print](#)
- ε Share Close
 - [Linkedin](#)
 - [Digg](#)
 - [Facebook](#)
 - [Mixx](#)
 - [My Space](#)

[Permalink](#)

- ⌄ Previous post [Stop Stop Too Big To Fail](#)
- ⌄ Next post [The Real Chicken-Checkup Fallacy](#)

Search This Blog

- ⌄ Previous post [Stop Stop Too Big To Fail](#)
- ⌄ Next post [The Real Chicken-Checkup Fallacy](#)

About Paul Krugman

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

- ⌄ [Biography »](#)
- ⌄ [Columns »](#)

Books

- ⌄ [Principles of Economics, 2nd ed.](#) (2009)
- ⌄ [The Return of Depression Economics and the Crisis of 2008](#) (Dec. 2008)
- ⌄ [The Conscience of a Liberal](#) (Oct. 2007)

Recent Columns

[Advertise on NYTimes.com](#)

[Going to Extreme](#)

By PAUL KRUGMAN

Has the Republican Party become more extreme, or is the country just beginning to notice?

[We're Not Greece](#)

By PAUL KRUGMAN

The United States may currently be running deficits of comparable size to Greece's, but its economic position and fiscal outlook is vastly better.

[Sex & Drugs & the Spill](#)

By PAUL KRUGMAN

Why weren't federal regulators working to prevent the BP oil spill?

[A Money Too Far](#)

By PAUL KRUGMAN

Greece may not be the next Lehman Brothers, but its problems are deeper than Europe's leaders are willing to acknowledge.

[Drilling, Disaster, Denial](#)

By PAUL KRUGMAN

The disastrous oil spill in the gulf could help reverse environmentalism's long political slide, but it will require leadership.

Archive

Select Month 

Recent Posts

May 17

[Et Tu, Wolfgang?](#)

If the euro isn't workable without highly flexible nominal wages, well, it isn't workable.

May 16

[An Upward Trend](#)

Lately, the Democrats have started exceeding expectations.

May 16

[How Will They Spin This?](#)

I'm sure that the climate deniers will find a way to ignore the latest facts. But I'm not sure what that way will be.

May 15

[Will 2010 be 1948?](#)

What if the GOP doesn't win the House?

May 15

[MisIMFormation?](#)

Hiding the real story in the fine print.

From the Opinion Blogs

[Freakonomics](#)

[A Simple Solution to Oil Spills?](#)

Hay and the cleanup effort.

[Dot Earth](#)

[Is Japan Seeing Internal Shift on Whaling?](#)

There are signs that Japan's appetite for whale hunts may be fading a bit.



Internet Explorer no puede mostr



What you get for ... \$300,000

ALSO IN REAL ESTATE »

[Long Island City comes into its own](#)

[House hunting in ... Austria](#)

nytimes.com

REAL ESTATE

Feeds

- ⌵ [Paul Krugman Blog RSS](#)
- ⌵  [Subscribe to Paul Krugman's Reading List](#)

[Home](#)

- ⌵ [World](#)
- ⌵ [U.S.](#)
- ⌵ [N.Y. / Region](#)
- ⌵ [Business](#)
- ⌵ [Technology](#)
- ⌵ [Science](#)
- ⌵ [Health](#)
- ⌵ [Sports](#)
- ⌵ [Opinion](#)
- ⌵ [Arts](#)
- ⌵ [Style](#)
- ⌵ [Travel](#)
- ⌵ [Jobs](#)
- ⌵ [Real Estate](#)
- ⌵ [Autos](#)
- ⌵ [Back to Top](#)

[Copyright 2010 The New York Times Company](#)

- ⌵ [Privacy](#)
- ⌵ [Terms of Service](#)
- ⌵ [Search](#)

- ε [Corrections](#)
- ε [RSS](#)
- ε [First Look](#)
- ε [Help](#)
- ε [Contact Us](#)
- ε [Work for Us](#)
- ε [Advertise](#)
- ε [Site Map](#)