

The Lowe Down

Lowe Institute of Political Economy

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Photo: NYSE trading floor



The Ongoing Financial Crisis

By Daniel Lockett '10

On Thursday afternoon, October 2nd, members of the CMC economics faculty were joined by representatives of the financial sector to have a panel discussion on the current financial crisis. Professor Willet captured one of the underlying causes of the crisis through the four most dangerous words in finance: "it's different this time". It is due to the fact that new financial products (i.e. Credit Default Swaps) were developed very quickly with too much faith bestowed in them that has caused much of the recent chaos in financial markets.

According to Mr. Flynn, who is the Vice Chairman and Chief Operating Officer at Union Bank of California, "this is the biggest modeling failure in the history of finance." Innovative financial instruments coupled with an epidemic of irrational public and private enthusiasm led to a new age of optimism in innovative financial products, when it was believed the old rules of regulation and oversight of risk did not apply.

So why is our government getting into the business of buying private firms' bad assets? Simply put, we are currently staring into the eyes of a financial crisis. There is no longer trust in financial markets. When trust goes, the credit market tends to collapse. When credit collapses, the economy grinds to a halt. Many government officials and economists believe the only way to avoid this crisis is to provide liquidity to the stagnant credit markets. This legislation essentially proposes that the Federal government purchase the toxic assets from many financial institutions in order to take them off of their balance sheets. This will boost the market of non performing assets. It is believed that this action will free up the credit

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An Interview With Professor Richard Burdekin

By Daniel Lockett '10

Lowe Working Paper: Sentiment Effects on Chinese Share Prices and Savings Deposits: The 2003 – 2007 Experience



Professor Richard Burdekin

Q: What is the main testable hypothesis of this paper?

A: The main testable hypothesis is the effect of investor sentiment on Chinese share prices relative to share prices in markets abroad, as well as its effects on savings deposit growth between 2003 and 2007. Sentiment has never been directly tested on Chinese securities, due to the fact that an investor sentiment series for China wasn't available until 2003.

Burdekin Interview—continued on Page 5

Message from the Director

As the new Director of the Lowe Institute of Political Economy, I would like to take this opportunity to introduce myself and discuss some of the Institute's new programs. I received my bachelor's degree in economics from the College of William and Mary and my Ph.D. in economics from the University of Illinois at Urbana-Champaign. I am a Research Associate of the National Bureau of Economic Research and a member of the Editorial Board of the *Journal of Economic History*. One of my current research projects examines how oil shocks impact the term structure of interest rates. When I am not teaching and researching, I like to play tennis and travel.

I believe that the primary mission of the Lowe Institute is to promote undergraduate education in economics and public policy. The Lowe Institute has initiated a new faculty student research project to support this goal. We are currently sponsoring nine different faculty student research projects with topics ranging from immigration issues in Africa to the performance of Chinese equity markets. The learning goals of the program are for students to learn how to use econometric software packages to analyze data and to learn how to test basic economic theories with data. As students gain experience from working at the Institute and taking advanced economic classes, we hope that students publish papers with faculty members. CMC Economics Professor Richard Burdekin and his former student Luke Redfern recently had their paper on Chinese equity markets accepted for publication at *Economics Letters*. There are currently three other Lowe sponsored papers under review that are co-authored with CMC students. The Lowe Institute hosts a barbecue twice a year to recruit student research assistants and to discuss current activities and programs.



Photo: Annual Lowe BBQ, Green Hall picnic area, Friday, September 19, 2008

The Lowe Institute has also recently started a joint speaker series with the college's Marian Miner Cook Athenaeum. A well-known economist is invited to Claremont to give a lecture to students and the public on an important public policy question. The next day the guest speaker presents an academic paper to the faculty of the Robert Day School of Economics and Finance. The Lowe Institute plans to sponsor up to six speakers each academic year. This year's program has focused on the financial and economic crisis of 2008.

The Lowe Institute is working to implement several new activities. We would like to increase the Institute's outreach to both the local academic and private sector communities. With respect to academia, we would like to establish a one-day conference in both micro and macroeconomics that bring scholars together from the leading colleges and universities in Southern California. On the private sector side, we are planning to publish a student run newsletter called the *Inland Empire Economics Bulletin*. The biannual newsletter will summarize and forecast economic conditions in the Inland Empire (Claremont, Pomona, and San Bernardino County) which is currently the fourteenth largest metropolitan area in the United States. We also hope to sponsor an annual economic conference that brings the public and private sector together to discuss an important public policy issues in the Inland Empire.



I would like to encourage all faculty, students, alumni and Board Members to participate in the programs and activities of the Lowe Institute of Political Economy. Feel free to drop by the Lowe Institute if you are in the area. We are located in offices 320 and 322 in Bauer Center. I hope that everyone has a happy and healthy holiday season.

Regards,

Marc D. Weidenmier

Maximizing Profits in Online Auctions

By Mark Gose '11



Professor Yaron Raviv

Last summer, Economics Professor Yaron Raviv and CMC senior Nathan Barrymore developed an experiment using EBay to determine the effect different reserve prices have on both sales revenue and the number of bidders in an online auction.

Generally, when using an online service like EBay, a seller can auction an item in four different ways. First, the seller can either place a public reserve price (a minimum price level) or a private reserve price (a minimum price level only known by the seller) on the item being sold. If buyers do not meet this price level (whether public or private), the product will not be sold. However, because EBay charges additional fees for placing reserve prices, sellers are sometimes reluctant to set a price level, so they either accept the given starting price of one cent or engage in shill bidding, an illegal method in which the seller uses multiple accounts to artificially bump up the sales price on his own product.

Raviv and Barrymore tested the effects of these pricing methods by auctioning off four \$25 Starbucks gift cards in three different trials using different price levels in each trial (\$10, \$15 and \$18.50). In the first trial, for example, there was a \$10 public reserve price on one card, a \$10 secret reserve price on the second card, with the minimum price on the third card being artificially set (through shill bidding) at \$10. Since there was no minimum price on the fourth card, bidding on that card began at one cent. The same pricing methods were used in the second and third trials, except the minimum prices in those trials were set at \$15 and \$18.50, respectively.

Based on the results of these three trials, they discovered that the higher price level yielded higher average revenue. In other words, with a reserve price of \$18.50, the cards were selling at a higher price than at a minimum price level of \$15 or \$10. What did not appear to make much of a difference was the method used to set the minimum price (private, public, or shill bidding). Although according to Professor Raviv, shill bidding is the best method from a seller's perspective because it requires no additional online fees, however, he acknowledges that this method is illegal.

Ultimately, their research paper provides valuable information regarding the approach to online auctions, and it serves as a strong foundation for further study. When asked about his experience, Barrymore remarked, "This project not only opened my mind up to a new topic but also brought me closer to academia and provided me with insight into how to publish a paper. I want to thank the Lowe Institute and Professor Raviv for giving me that opportunity."

CALENDAR OF EVENTS

Winter Meeting of the Lowe Institute Board of Governors

Tuesday, February 3, 2009—noon

Lunch Seminar—Joe Davis, Chief Economist, Vanguard Investment Corp.

Wednesday, February 4, 2009

Lowe-Athenaeum Speaker Series—Dan Hamermesh, Professor of Economics at the University of Texas

Thursday, March 5, 2009—5:30 pm reception, 6:00 pm dinner, 6:45 program

"This project not only opened my mind up to a new topic but also brought me closer to academia and provided me with insight into how to publish a paper."

Interview with Luke Redfern

By Daniel Lockett '10



Photo: Luke Redfern

“The Lowe provided me with the tools to make a pitch and to prove a point, which is essential for my job.”

Q: Describe your experience at the Lowe Institute.

I worked at the Lowe my sophomore year, and for part of my senior year. Overall, it gave me a lot of exposure to data analysis and Microsoft Excel. Just from working there for one year, I learned how much I love to crunch and analyze numbers. Working at the Lowe was a positive experience for several reasons. First, when working at the Lowe you have the freedom to work whenever. Second, finding out which numbers are significant and how those numbers represent the research idea professors are looking at opened my eyes to the academic viewpoint of data analysis. Lastly, knowing you are contributing to research of such magnitude and significance is certainly one of the highlights of the work experience you gain while working at the institute.

Q: Your thesis topic was a result of your research with Professor Burdekin. How does it feel to now have your thesis up for publication?

I feel lucky because I came up with an idea that in the end worked out really well. Overall, my work at the Lowe made me proud and grateful. I am proud in the sense that I was able to successfully find the data that supported my idea. And I am grateful for Professors like Burdekin who provided me with a springboard to get started. His guidance was instrumental in that he pointed me in the right direction and gave me crucial pointers.

Q: What tools did you gain as a result of working at the Lowe Institute?

The main tool I gained is how to efficiently analyze data. At the Lowe, I learned the crucial combination of critical thinking and technical skills that allowed me to do serious quantitative analysis. In the classroom, you do not get the hands-on application experience. It is a different way of thinking because you not only have to understand what is going on, but you also have to go a step further and apply the theory to the real world.

Q: How did working at the Lowe help you in your coursework at CMC? How did your experience prepare you for life after graduation?

My work at the Lowe prepared me well for the coursework at CMC in economics. It helped me gain the perspective that allowed me to look at a problem or subject and understand it at a macroeconomic level. Taking knowledge from the classroom, primarily based in theory, to an applied level considerably enhanced my understanding of economics. My experience at the Lowe, researching with Professor Burdekin, also made me a lot more comfortable with and knowledgeable of my career choice. I discovered that I love research and crunching numbers. Today, I am doing what I love, working as a market analyst for Credit Suisse in Los Angeles. A lot of times on the job, day to day, you need to be able to tell a story about an industry or specific market. The Lowe provided me with the tools to make a pitch and to prove a point, which is essential for my job. Through my work there, I obtained the means to not only know the answer to a particular question, but also the ability to understand each step of the process in depth.

*Since this interview with Luke, his thesis has been accepted for publication by *Economics Letters*.

Alan Taylor at the Athenaeum

By Seth McCormick '12



Photo: Alan Taylor

On the evening of October 27th, Alan Taylor, a professor of economics and director of the Center for the Evolution of the Global Economy at UC Davis, traveled to CMC's Athenaeum to give a presentation on the current financial crisis. The talk, sponsored by the Lowe Institute of Political Economy, had a great turnout, and Taylor's keen wit kept the audience laughing despite the gloomy subject. Not seeing much need to explain the importance of his topic, he dove right in.

His goal, he said, was to answer the question of where this “crash of epic proportions” came from and where it will go next. Taylor explained that the current situation is often blamed, incorrectly, on macroeconomic causes. Though the U.S. deficit has indeed been significantly financed by developing countries and we have been living in a “savings glut” era, the consequent depression of interest rates is not to be blamed for today's crisis. To prove his point Taylor cited the collapse of the housing bubble in the early 1990's, when there was a high interest rate environment. He insisted, “I don't think we should be afraid of a low interest rate world.”

This time, though, the crisis is much bigger—“that really horrible bubble back in the early nineties... it's just a tiny blip compared to what we have now.” Taylor thinks it has to do with developments in the financial sector such as increased leverage, failure in risk management, and other *microeconomic* issues. He does say, however, that the main underlying cause of the disaster was without a doubt from the housing sector.

While there are several possible reasons for ballooning house prices, Taylor argues that it is definitively the entry of unqualified buyers that drove the calamity. Though now “nobody will touch such a borrower with a ten foot pole,” unscrupulous lenders freely gave out risky loans to imprudent buyers, each rationalizing that housing prices would continue to rise. Despite such self-deception, “for the most part,” the originators of the mortgages “weren't stupid enough to keep these mortgages on their books; they got their friends at the rating agencies to put triple A ratings on them” and sold them to anybody foolish enough to take them.

The problem came when “all this toxic stuff” began to pile up in banks. The high risk meant high returns, but with such unethical lenders

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Burdekin Interview—Continued from Page 1

Q: How did you test this hypothesis?

A: After obtaining the information on the investor sentiment series provided by the People's Bank of China, data for several other ingredients were needed. One ingredient is the alternative stock price series. This series shows the substantial difference between the price of a share of a particular firm in local Chinese markets and the price of the same share in markets abroad, such as in the Shanghai market. In this paper the reason for why this discount between the two share prices fluctuates over time is studied in depth. Another question researched is the role sentiment has on the growth of savings deposits in China. As Chinese markets soared, many of these funds came out of personal savings. Historically, the Chinese have had a high level of savings by world standards and, until recently, these deposits were the only place citizens could legally put their money. This all changed at the beginning of the 21st Century with the new accessibility of the stock market.

Q: What are the implications of your findings?

A: Ultimately, the data shows that bullish local Chinese investor sentiment increases the discount on shares abroad, while bullish sentiment abroad decreases the discount. This discount on the shares in markets abroad averaged about 50% when compared to Chinese shares in local markets. Clearly, this discount is the result of several factors. One factor is the capital controls that prevent mainland Chinese investors from investing abroad, but this factor does not fluctuate because it is a permanent restriction, thus having a constant effect on the price discount. As a result of the research, it is found that investor sentiment accounts for the majority of these fluctuations. Also, the draining of Chinese savings deposits coincides with a dramatic increase in investor sentiment throughout China. For example, when sentiment soared in Chinese markets during the first four months of 2007, the equivalent of 10 billion U.S. dollars in Chinese currency transferred from savings accounts to stock market accounts. On May 8th, 2007, 421,831 new stock accounts opened. This highlights the significance of investor sentiment in Chinese markets.

Q: Does this paper provide any insight into an existing theory?

A: This research provides a lot of insight into the existing theory surrounding investor sentiment. One aspect of this paper is that it shows how sentiment plays a significant role not only in developed markets but also in less developed markets. Currently, negative investor sentiment worldwide is undervaluing many companies, as opposed to overvaluing. “This existing theory is currently at work right now in the global economy” says Professor Burdekin, “however we are experiencing the opposite extreme of the investor sentiment phenomenon.”

Low Working Paper: Can a Lender of Last Resort Stabilize Financial Markets?

By Mark Gose '11

With all of the recent news about the government's multi-billion dollar economic bailout bill, one might ask whether injecting money into the financial markets is a viable way to buoy our economy.

Well, last summer CMC economics Professor Marc Weidenmier and Professor Eric Hughson, with Harvey Mudd College senior Asaf Bernstein, conducted a study to determine whether or not a lender of last resort (an institution that provides liquidity assistance to financial markets in a crisis) can stabilize the economy. Their research is based on Bernstein's senior thesis, "Can a Lender-of-Last-Resort Stabilize Financial Markets? Lessons From the Founding of the Fed." After being reviewed by Weidenmier and Hughson, Asaf's thesis has been submitted to the *Quarterly Journal of Economics* for publication.



Photo: Professor Marc Weidenmier speaking at the Athenaeum on September 30, 2008

They examined the period before and after the creation of the Federal Reserve because "from a statistical standpoint, it is easiest to see the impact of a lender of last resort when you go from not having one to having one," says Weidenmier.

Prior to the founding of the Federal Reserve in 1913, the Aldrich-Vreeland Act of 1908 was enacted to address the illiquidity in the American banking system that inevitably arose during September and October each year. During these months, farmers harvested crops and then borrowed large sums of money to finance the transport of those crops to markets in both the United States and Europe. As a result, banks became practically insolvent and were largely unable to provide financing to the rest of the economy. In response, the Aldrich-Vreeland Act (later replaced by the Federal Reserve Act of 1913) was passed which granted certain banks access to emergency currency during a financial crisis, establishing the concept of the government as a lender of last resort.

Since it is clear that this new monetary policy would have the biggest impact during the months of September and October, Bernstein compared the volatility of the financial markets in these two months against the rest of the year both before and after the Aldrich-Vreeland Act and the creation of the Federal Reserve. According to Weidenmier, "If the monetary policy matters, September and October should look a lot more volatile prior to the change, but after the change these two months should look like the rest of the year."

Weidenmier, Hughson, and Bernstein discovered that once the government provided these emergency funds, stock volatility during this two-month period fell by nearly 50%, and the interest rate volatility fell by more than 70%! This substantial drop in volatility provides evidence that injecting liquidity into the banking system can, if done correctly, stabilize financial markets. Most importantly, this stability is conducive to greater investment and economic growth.

Although we cannot know for certain whether the present bailout plan will solve the current economic meltdown, the study done by Bernstein, with the guidance of his two mentors, is proof that a lender of last resort can help stabilize broken financial markets.

Asaf now works for Citigroup creating the quantitative trade analysis programs used by the firm's traders. He has been so enamored by his experience with independent research that he now plans to pursue a Ph.D. in finance. Though he won't necessarily become an academic, he says that "doing thesis at CMC is one of the main reasons that I decided to leave my high paying wall street job to be a poor graduate student."

The John Roberts Theorem

By Stephanos Stroop '10

Professor Helland:

When Professor Eric Helland isn't teaching students in economics, he is doing top research as the head of the RAND Corporation. One of his most recent ventures at the RAND was done in conjunction with the Lowe Institute, which involved researching judicial resources. The primary goal of this research was to determine if there was any correlation between lower pay for state court judges and the turnover and exit rates of these positions. He referred to the correlation of lower pay and increased exit as the John Roberts Theory. Roberts' theory applies to federal court judges, but Professor Helland was determined to see if it applied to state court judges as well.

Before testing the theory, Professor Helland and his research team had to attain the data, which consisted of researching the salaries of state court judges from 1977 to 2007, the duration of their tenure, and the quality of their rulings as a judge. They found significant variation in the judges' salary due to the location of the judge (i.e. judge in Montana vs. judge in California) and due to the judge's experience. The tricky part was determining the quality of the judge, due to the subjectivity of such a rating. Their measure of quality was how many "opinions of the court" were written by the judge and the number of times they dissented. In other words, a poor quality judge more frequently agrees with the majority due to laziness and rarely writes up an opinion speaking for the court.

So far, Professor Helland's study is the first to find any correlation between pay and exit suggesting Justice Roberts' Theory is correct... at least for state courts. Now they have to determine how useful and applicable this result is. With such a broad definition of quality, it is hard to make any significant claims as a result of these findings. However, these findings do help prove the labor economics theory of work vs. shirk. A judge who shirks writes fewer opinions and agrees with the majority whenever possible because they know that if they get fired, there are better career opportunities. Lower pay means the worker will just move on to the next best option which for a lot of judges is either becoming partner at a law firm or becoming a private judge. It makes sense to increase the salary for a job that is high risk, but since these jobs are relatively safe, lower pay is acceptable whether or not it is conducive for attracting a quality judge. If this theory is eventually proven, it will certainly lead to judges seeking higher pay.

Maria Lohner:

Maria Lohner was the supervisor of the team of research assistants for Professor Helland's research on judicial resources. She and her fellow researchers had the tedious task of going through fourteen hard copy books and inserting this data into excel. Maria felt she learned numerous skills that will benefit her in the future including the following: managerial skills, motivational tactics, how to lead efficiently, working with a team, how to handle data that needs to be standardized, as well as mastering excel. She went on further providing examples of how she was able to motivate the research team by helping them stay focused on the big picture instead of getting bogged down in the significant amounts of data. Her use of long term goals as well as short term goals helped create a sense of progress and consistent accomplishment which was instrumental to the success of the project.

All in all, Maria views her time working at the Lowe and the RAND as a great experience. She thanks her efficient team of researchers, Kelly Spetnagel for her assistance, and Lowe for providing computer lab space.

Lastly, she couldn't stress enough how great it was to work for Professor Helland and to have him as a mentor.



Photo: Maria Lohner '10

*Note: The other research assistants for this project were: Harsh Chowdhary, Aaron Champagne, Matt Beienburg, Nathan Doctor, Rajat Gupta, Aditya Bindal, Elaisha Nandrajog, Kyle Casella, Joshua Redel, TJ Moss, Lindsey Morgenthaler and Meghana Reddy.

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markets by allowing these firms to lend and borrow as opposed to hoarding liquid assets in the face of future losses and poor economic conditions.

Throughout the panel discussion, several conceptual reasons were emphasized as causes or effects of the current financial crisis. A concept frequently referred to is that deregulation did not cause this crisis; it was “unregulation.” Many if not all of the necessary institutions and instruments exist, however these tools were not being used. Over the last ten to fifteen years regulatory policy became reactionary instead of active and pro-cyclical instead of anti-cyclical. Essentially, these regulatory entities such as the SEC were complacent and even borderline lazy. Another concept mentioned is moral hazard, which is defined as the lack of any incentive to guard against a risk when you are protected against it, has been increasing in the financial sector. After a similar crisis involving savings and loans banks in the late 1980’s, the Federal government bailed out several of these banks setting the precedent. It is apparent that U.S. financial institutions remembered this bailout and it has certainly played a factor in their investment strategies for the worst. Lastly, there may have been some overconfidence in the economy. As things go well people become confident and begin to discount risk much more. Once fear drives the markets downward, investors begin to panic and start to care about the accessibility of their money as opposed to the returns on it. This leads to many investors turning to treasury bonds as a safety haven. These new financial products did not properly diversify risk and the institutions selling them knew this. At every point in the financial system it was believed “someone else” would detect something wrong and save the integrity of the system; however now it is clear that everyone was blinded by greed.

Professor Marc Weidenmier put events into their proper historical perspective, addressing the common comparison of the current financial crisis to the Great Depression. One statistic pertained to mortgage delinquencies which today are at 4% and during the

Great Depression were at 40%. Another statistic provided was that the unemployment rate today is 6.1% while during the Depression it was an astonishing 25%. Overall, it can be concluded that this financial crisis is not and will not be as bad as the Great Depression due to what we have learned from it and the quick response from the government. For example, the steps recently taken by the Federal Reserve emulate the actions of the Reconstruction Finance Corporation, a government entity created during the Great Depression. These actions include closing the weakest banks, recapitalizing the sounder financial institutions, and taking control of some banks by replacing their management.

This unprecedented government action which threatens the very foundation and principles of a free market capitalistic system raises grave concerns. Having the precedent of Uncle Sam basically writing checks in order to bail out banks will have huge ramifications for the economy. Moral hazard, as a result of minimal consequences for these institutions that knowingly took on too much risk, is dangerously high. Professor Marc Weidenmier had this to say pertaining to the government’s response to the crisis: “I have yet to see a credible plan hit the floor that has some sort of punishment mechanism such that the incentive structures are structured correctly so that CEO’s and directors of banks have to worry about the consequences if they make a bad decision.” Whether or not the bailout plan is a success, the government has thus far failed to address several of the underlying causes of the current crisis. Every panel member agrees that the Federal government needs to adopt a more nimble and dynamic regulatory system that anticipates financial innovation and addresses the new challenges brought on by an ever changing global economy.

2008 Research Assistants

Baker-Lowe Scholars

Jennifer Ambrose ‘09
Amanda Yang ‘10

RAND

Aditya Bindal ‘11
Kyle Casella ‘10
Aaron Champagne ‘10
Harsh Chowdhary ‘10
Nathan Doctor ‘11
Rajat Gupta ‘11
Maria Lohner ‘10
TJ Moss ‘10

Faculty/Student Projects

Jaron Abelsohn ‘11
Candace Adelberg ‘10
Matthew Beienburg ‘11
Rebecca Burns
Justin Eskind ‘11
Sean Hannley ‘10
William Heinke ‘10
Marya Husain ‘09
Meghana Reddy ‘10
Joshua Redel ‘10
David Regalado ‘09
James Richardson ‘10
Jyotsna Shankar ‘11
Mitchell Skotarczyk ‘11
Ronald Wu ‘11
David Xu ‘11
Yuchen Zhang ‘10

Putin's Peculiar Power: Cliff G. Gaddy at the Athenaeum

By Stephanos Stroop '10



Photo from left: Clifford Gaddy, Marc Weidenmier, Stephanos Stroop '10

At the Athenaeum on Monday night, October 27th, Cliff Gaddy of the Brookings Institution came to discuss Russia's sudden reemergence as an economic force focusing on how Vladimir Putin runs the powerful Russian state. Now with low energy prices, which the Russian economy historically fluctuates with, Russia's recent rise may end up being short lived. Addressing this issue, Putin recently made a comment stating "we didn't allow ourselves to be caught off-guard" referring to his conservatism in stockpiling foreign currency. Russia stockpiled so much currency that Russia is now one of the biggest financiers of the United States. This economic strategy exemplifies Putin's foresight as well as his perceived ability to handle the current crisis.

Russia's reemergence is scary mostly because it was so unexpected and sudden. After the fall of the Soviet Union, Russia was an afterthought. As recent as the late 1990's, their debt was greater than their foreign currency reserves. The swiftness of Russia's rise can be partially attributed to blindness caused by the west's own hubris. Western powers never thought Russia could return to international power with a strong government, especially within a period of less than ten years. In his speech, Dr. Gaddy focused on the two key areas of the economy, specifically oil, as well as an internal political system that began in the 1970's.

Some economists refer to oil as a curse because governments proverbially put all their eggs in one basket and the economies of these governments inevitably become as volatile as the price of oil. These economies become so intricately linked to oil prices that they develop the same boom and busts cycles as oil. Russia is certainly no exception. Dr. Gaddy showed that The Soviet Union lasted longer than it should have because of the 1970's oil boom and how the Soviet economy collapsed with the fall in the price of oil below \$20 a barrel in the 1980's. The Soviet Union had to replace this substantial loss in economic value so they took out loans from private western banks. Unfortunately for the Soviets, oil prices remained depressed and these loans became so large that the western governments eventually had to take on the loans. It was the political strings attached to these loans that ultimately led to the fall of the USSR.

When Putin came to power in 1999 as Prime Minister and then as President later that year, there was still a lot of oil in Russia but it was concentrated in the hands of a few wealthy individuals. Putin understands that private ownership is a better economic entity than state ownership, but he had to find a way to har-

ness the wealth of private corporations. So Putin did three things. The first of these was his tax reform which implemented a flat tax that has resulted in more tax revenues. Second, Russia's oligarchs were successful at bribing Russia's regional governors so Putin decided to remove the object being bought. He created a vertical system of power by appointing the governors himself and by making their chief goal to collect money for the central government. Lastly, he created what Gaddy called "property rights protection racket." In other words, the government threatened to go after the wealth of the oligarchs if they did not start philanthropic endeavors in order to help the nation. For Putin, it was embarrassing that the United States was one of the largest funders of philanthropy in Russia. Putin wanted patriotic, nationally-minded businessman who could be called "magnates" instead of oligarchs.

Political developments, including changes in governmental structure itself, also played a huge factor in the rise of Russia. It all began in the 1970's when Yuri Andropov was named head of the KGB, the USSR's secret police. Andropov was aware that the communist system of recruiting at the KGB was flawed and that he would have to pick between preserving the state or the system. In the end he picked the state. At the time, the threats to the government were from members of the church, the youth, and the intelligentsia. Andropov sold the government on the idea of keeping your friends close but your enemies closer by recruiting elements of those threats into the KGB so they could be monitored. In reality, Andropov just wanted the best and brightest serving him which was only possible without the restrictions of the current system which only recruited loyal communists. According to Dr. Gaddy, Andropov stressed the romanticized viewpoint of "brains over brawn." It was these changes in the system that allowed Putin as an intelligent youth to join the KGB. Andropov influenced future leaders, specifically Gorbachev and Putin, both through his actions and strong opinions. Dr. Gaddy argues that it was Andropov who laid the groundwork and helped Putin become the type of leader he is today.

Dr. Gaddy was insightful and even humorous at times throughout his presentation on the rise of Russia and the man behind it all, Vladimir Putin. The timing of his visit was perfect in that Russia has recently been the center of the world stage, considering the Russian invasion of Georgia and their new role as an economic superpower. We will all see if Russia can continue its rise on the world stage despite declining oil prices, and it is definitely something to closely observe over the next couple of years. We hope Dr. Gaddy enjoyed his time at Claremont and that he will return in the future to share his thoughts and update us on the status of the Russian state.



Photo: Barry Eichengreen

PEIF Conference Comes to Claremont

By Seth McCormick '12

CMC was host to the 2008 Political Economy of International Finance Conference (PEIF), with Professor Weidenmier in charge of the event. Originally established by UC Berkeley's Andy Rose

and Barry Eichengreen, the conference has previously been held at Harvard, Michigan, Berkley, Georgetown, Emory, and UCSD. This past spring it was held at CMC, and it brought together approximately forty professors of economics and political science as well as several representatives of the International Monetary Fund and World Bank, each chosen based on papers submitted to the conference committee. The focus of the conference was debt markets, which coincidentally happens to be Professor Weidenmier's specialty.

The conference, which began on May 1st, was a joint venture sponsored by Claremont Graduate University, CMC, the European Union Center at Scripps, the Financial Economics Institute, the Lowe Institute, and Pomona College. The first event was a talk given that evening by Barry Eichengreen on the future of the European Union which he says will not break up any time soon, if for no other reason than the sheer cost (e.g. currency change) of doing so for member countries. The conference itself began the following Friday, and the keynote address was also given by Eichengreen. He argued that the U.S. dollar supplanted the British pound sterling in the 1920's rather than the commonly accepted 1960's, and made the parallel argument that the euro may, in turn, supplant the dollar sooner than anticipated.

Besides Eichengreen's keynote address, attendees were treated to multiple other lectures. Stephen Quinn from the Texas Christian University discussed "how Britain used privileged corporations to simultaneously securitize and restructure sovereign debt." Randall Stone of Rochester addressed the issue of International Monetary Fund conditionality and the role played by member countries in determining it. Henrick Enderlein, Laura Muller, and Christoph Trebesch from the Hertie School of Governance in Berlin identified "which political and economic factors explain unilateral government actions towards international investors in times of financial distress." Jamus Jerome Lin from the World Bank proposed a model for post-economic crisis redistributive effects and policy. And lastly, Rohan Pitchford from the University of Sydney and Mark Wright of UCLA discussed the restructuring of the sovereign debt mechanism.

Sean Hannley : A Dedicated Research Assistant

By Daniel Lockett '10

Q: What did you learn through your work at the Lowe Institute?

A: I have worked on a number of different projects at the Lowe and have been exposed to a wide variety of different subtopics in economics. For the last three years I have worked at the Lowe Institute which has given me the opportunity to study everything from insurance fraud to monetary policy, and from capture theory to bond pricing.

Q: What are some of the projects you have worked on?

A: Well, the paper I'm working on now is about World War II. The paper analyzes bond prices during the war to determine the effects of certain military events on the likelihood of defeat for the Axis powers.

Two summers ago, we furthered existing theories that the president of the US will engage in avoidable wars if the country is in recession and the likelihood of winning a second term is low. Although we studied post American Civil War conflicts between the U.S. government and Native Americans, the theory has also held true in numerous conflicts after WWII.

The first project I worked on at the Lowe Institute was about the Barings Crisis, one of the first global financial crises. The paper looked for the sort of contagion effects that were felt in the East Asian Crisis in the late 1990s.

Q: How has your work at the Lowe Institute helped you in your courses?

A: Both the theoretical and quantitative aspects of my work at the Lowe have been useful in my courses. It's nice to work with certain models and ideas before, during, or even after taking the relevant course. Also, the sort of "hands on" work at the Lowe, where we deal with large datasets was helpful for me. These skills are very useful in classes such as Econometrics or Time Series Analysis, where we are asked to build and manipulate our own datasets for papers.



Photo: Sean Hannley '10

Professor Blomberg: War Profiteering: Fact or Myth?

By Stephanos Stroop '10

Recently, Professor Brock Blomberg published a paper on whether or not War Profiteering still exists. This was especially a hot topic this past spring as the price of oil soared over \$100 a barrel and oil companies were posting record-breaking profits. For War Profiteering to be a possibility, several circumstances must precede. For one, there has to be a monopoly on the supply of oil to the point that the monopoly can effectively dictate the market price. Another circumstance is that a war or an event has to constrain or disrupt the supply available.

In order to research this subject, Professor Blomberg and his team of assistants looked at events that could affect the supply of oil as well as the business operations of twelve major oil companies. When researching the oil companies, the focus was on where they did their business of refining and exporting. From there, he focused his research on when these areas of business were disrupted by conflicts and then studied the company's financial statements (particularly profits) during that same time period. The results of the research found that War Profiteering occurred up until the 1st OPEC shock in 1973. Since then, new technology combined with new sources of oil that have been discovered makes War Profiteering only theoretically possible. Like previously stated, if the conditions were right in terms of market control and capacity constraints it could potentially happen, but there is an infinitesimally small chance of War Profiteering occurring today and in the future.

So what does this all mean? For one, politicians should reconsider demonizing and castigating the oil companies. These companies might be turning huge profits but they are not exploiting the situation. What is most significant about this project is that its research and findings are unprecedented. Professor Blomberg could not find a relevant previous existing theory pertaining to the subject. Hopefully his work can help dispel the myths portraying oil companies as blood sucking leeches.



Photo: Student working at the Lowe computer lab

Hunter Jackson:

Hunter Jackson was a research assistant under Professor Blomberg for his research on War Profiteering. Hunter's main tasks for the project included the following: performing a literature survey on the subject, collecting the financial and conflict data, writing parts of the paper as well as the computer code, and even presenting on the topic to the Lowe Institute. From this assortment of responsibilities and his experience, Hunter learned multiple facets of research, publishing, and academic writing as well as skills involving statistical analysis, econometrics, and the use of programs such as excel and STATA. This research also educated him more on the subject of War Profiteering and its rich history. All of these responsibilities and endeavors helped develop his analytical abilities and creativity.

As for the actual research, Hunter views it as an incredibly important issue especially because of its sensitivity in the last year or so. Many people worldwide accused the oil companies of manipulating conflicts, particularly in the Middle East, to line their pockets with profits while people suffered from high energy costs. But this issue is not new, it has a long history. For many decades, the assumption was that oil companies profited from conflicts when in actuality trends show it hasn't been the case since the 1st OPEC shock in 1973.

In the end, Hunter felt the overall experience with this project and working at the Lowe Institute was a very positive one. He learned a lot and met many of the professors that work at the Lowe. Most of all, Hunter said he was grateful because he had the opportunity to work with Professor Blomberg on a project of academic significance.

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Alan Taylor—continued from Page 5

and S&P employees saying that loans “could be structured by cows and we would still rate it,” the risk turned out to outweigh the reward. Banks that began with only 1% of their holdings with a loan-to-value (LTV) ratio over 90%, soon had over 22% holdings at the same high ratio. And when the homebuyers began to default, the banks had no recourse and could do nothing but accept the collateral. The result? “Now you have a lot of distressed banks, banks that are either insolvent or very nearly so.”

“Basically there is this huge failure of risk management and monitoring and control, not to mention an abuse of trust. People were doing things for the fast buck, that in the end would not generate” sustainable circumstances. Lenders, paid on commission, were too eager to give loans, and banks were too willing to hide that they were “made of junk.” It wasn’t until people looked at interbank lending that the extent of the problem was realized and the Fed stepped in. The Fed began by simply taking some of the bad paper off the balance sheets of banks, hoping to “twist” interest rates in interbank lending without having to change the overall interest rate.

It was with the failure of Lehman Brothers that “everything blew up,” and we left what Taylor de-

scribed as a “state of suspended animation. This is when things reached a crisis point.” With banks becoming insolvent and retracting credit, it became a real economic problem. “A few people in mortgage origination are taking down the global credit market,” and the policy response has been shoddy at best. The current plan is better than initial proposals, but equity purchases and capital injections are still rather vague.

In the end, Taylor says, countries will survive to make changes, and if the new administration acts with anything close to the expediency of FDR, we might make it out of the woods sooner rather than later. “Everything is going to hell in a hand basket, but the dollar is strengthening.” If we bite the bullet and clean up the system, we may be able to “both save capitalism from the capitalists and from the socialists.” When asked whether this signals the end of the age of securitization, Taylor responded “certainly not.” Though more banks may fail, and perhaps ought to be allowed to do so, the means will be generated to fix these failures in oversight and professionalism that define this mess that we are now all in.



Photo from left: Steph Stroop, Seth McCormick, Mark Gose, Dan Lockett

LOWE INSTITUTE OF POLITICAL ECONOMY

CLAREMONT MCKENNA COLLEGE



500 E. Ninth Street
Bauer North 320, 322
Claremont, CA 91711
USA

Tel: 909-621-8012

Fax: 909-607-8008

E-mail: lowe@cmc.edu

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