
Financial system a 'con game,' says economist

By Editor Test Wed, Apr 20, 2011

An ideal pension system would be based on an annual contribution of 8% of wages to a government-run index fund, said Laurence Kotlikoff of Boston University.

The world's financial system is tantamount to "a Ponzi scheme" and the U.S. bailouts of AIG and other entities worsened its problems according to Larry Kotlikoff, professor of economics at Boston University and former adviser to the president.

Speaking at a pension conference in Wassenaar, the Netherlands, Kolitkoff also likened the financial system to "a con game, characterised by a pervasive lack of transparency and made up of fraudulent guarantees and financial promises that cannot be kept," *IPE.com* reported.

"AIG insured the uninsurable, and now the US government has taken over that role," Kotlikoff said. "But managing the crisis by taking on promises you can't deliver is not a fix to systemic risk. It is itself systemic risk."

If one were to count the "unofficial" liabilities in US entitlement programs that are presently being kept out of the picture by bogus accounting, the US is actually in worse shape than Greece, he said.

"To cover all those liabilities, federal taxes would have to be raised by 64%, or expenses would have to be cut by 40% - and that is an optimistic estimate," he said.

The financial system is inherently fraudulent, Kotlikoff said, because financial institutions insure the uninsurable and take on liabilities they cannot honor, while these institutions and their managers themselves take on only limited liability and pass the buck to the tax payer when things go wrong.

The only way to fix this sorry state of affairs is by introducing what Kotlikoff calls "limited purpose banking."

Financial institutions should be turned into mutual funds or mutual insurance companies with unlimited liability, under supervision of an independent financial authority that would be responsible for verification, appraisal, rating and enforcing full disclosure.

A mutual fund selling shares and investing or lending out the proceeds without the use of leverage makes no promises it cannot keep, nor does it require government guarantees, Kotlikoff said.

Likewise, risks could be insured using ancient 'tontine'-style vehicles, which mutually insure risks without any attempt to insure the aggregate - and thus uninsurable - risk.

The Dutch pensions system, too, is at risk of going under because it makes promises that cannot be kept, he said.

An ideal pensions system would cut employers out of the picture entirely because “companies have their own interest at heart”, and those interests do not include providing employees with a good income after retirement.

Much better to have the government introduce mandatory savings of about 8% of wages, to be invested collectively in a globally diversified index fund at virtually zero cost, he said.

“The government could then guarantee that people would get what they put in adjusted for inflation, and people could turn to tontine funds to take out additional insurance,” he added.

Kotlikoff also said he hoped his views would resonate in the Netherlands and inspire measures to overhaul the financial system.

“Don’t expect the US to take the lead in this. We are the ones who created this mess in the first place,” he said. But unless the US gets its fiscal house in order, fiscal problems could well trigger a second, and far worse, financial crisis, Kotlikoff warned.

“Once people figure out the government can’t actually deliver what it has promised, other than by printing huge amounts of money, this may trigger a bank run,” he said. “PIMCO has already said it will buy no more US Treasuries, which is not a good sign.”

Kotlikoff, a former senior economist on the presidents Council of Economic Advisers, has proposed a radical overhaul of the financial system in his book *Jimmy Stewart is Dead – Ending the World’s Ongoing Financial Plague with Limited Purpose Banking*, which was endorsed by Mervyn King, governor of the Bank of England.