NOTES ON THE CRISES

Liquidity, Volatility and Market Craziness: Paul Krugman Interviews Nathan Tankus Again

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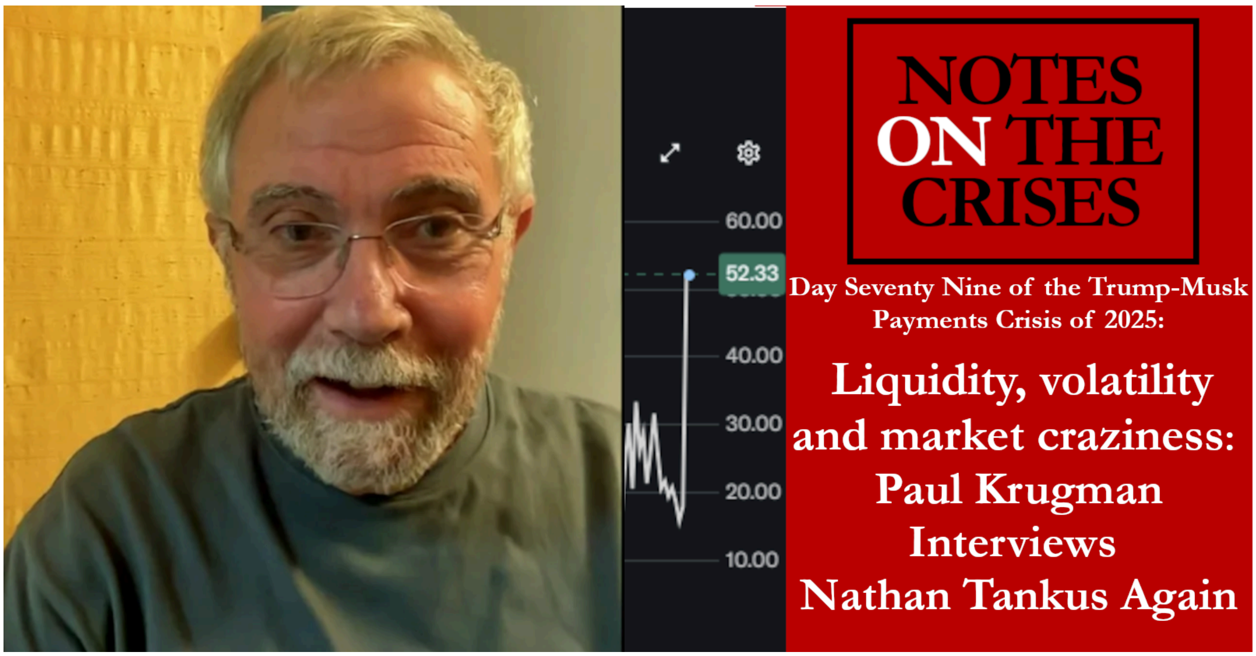
By Nathan Tankus



Exactly seven weeks since the first interview Krugman did with me was published, I have another interview to bring readers. It's quite surreal to be something like a regular correspondent for Paul Krugman on what's happening. Even more so because this interview is not particularly focused on, say, the Treasury's internal payments system or the technicalities of the Automated Clearing House payments system. Instead it's focused on the bread and butter elements that make up a modern financial crisis

One reason this is surreal for me is that I first got interested in economics when, in January 2009, I took a class called "Show Me the Money" at Urban Academy Laboratory High School that was all about the Great Financial Crisis of 2007-2008 that had just happened. Krugman's articles were a regular feature in that class. I don't think I could have imagined then that sixteen years later Paul Krugman would be regularly inviting me onto his "show" to explain what's going on- including with a burgeoning financial crisis. Life truly takes you to strange places.

Speaking of strange surreal experiences, it's time to tell readers other exciting news: I've signed a lease for a Notes on the Crises office in Manhattan! It is unbelievable that the generous support of readers has gotten me to this point, but it has. My vision for this office- in its entire 2000 square feet glory- will be explained in detail in the coming weeks and months. For now I'll just say that this office will allow me to greatly expand my activities and facilitate creating a community of interested experts, researchers, freelancers, and volunteers- and with enough funding and support, perhaps even employees…- to do more reporting on a greater number of topics. It also facilitates me building a professional audio/video set up so that Notes on the Crises does not simply live in the written word. Furnishing the office is moving quickly and the office should be functional, and open to interested parties, by the end of next week. For security reasons I am keeping the location of the office confidential- events with subscribers will happen elsewhere.

Finally, I'd like to end with what I said in the introduction of the [previous Krugman interview:]

> **If you want to take on Krugman's concern** about what happens **"if you get hit by a truck"** and my answer "If someone out there who's watching this or reading the transcript wants to put up a budget, $500,000 or a million to train up people and, you know, make me

replaceable, I'm more than eager to train up my redundancies." You are more than welcome to email me at Crisesnotes@gmail.com or contact me on signal at NathanTankus.01

Paul Krugman's Introduction:

Nathan Tankus has become an essential resource during these strange and scary times. My last chat with Nathan was about DOGE's depredations at government agencies. This time I spoke with him about disruptions in financial markets.

I continue to be astonished at how important the "plumbing" of these markets — the stuff that makes them function, which we normally don't even notice — becomes when everything falls apart. And economists in general don't know that much about the plumbing, so we need help from people like Nathan who do.

One thing that struck me during the conversation was Nathan's explanation of the partial easing of financial stress after the crazy tariffs announced April 2 were replaced by the equally crazy tariffs of April 9. He points out that while a serious analysis of the April 9 tariffs showed that they were as bad in their own way as the original tariffs, the narrative was that policy had eased. And markets, he insists (and I agree) are less information processors than conventional wisdom processors.

Much more in the interview. Transcript below.

TRANSCRIPT:
[recorded 4/16/25]

Paul Krugman: So hi. Paul Krugman again.
I'm doing a second session with Nathan Tankus, who is everywhere these days.
He's really in the middle of it. And last time we spoke it was really about DOGE which has by no means gone away as an issue but we're also having crazy action in the financial markets, which is in some ways, Nathan, where you came into this whole discussion. I want to try and actually figure it out myself, but also walk listeners through what's going on.
So welcome. I guess this is my show these days.

You were actually warning about a potential financial crisis before the whole post Rose Garden stuff. You want to tell us about what you were thinking and we can go from there?

Nathan Tankus: Yeah. So, I've been calling this series since it started January 31st, the "Trump-Musk payments crisis." And so this is a lot of what we talked about last time, All of the different ways that this system could blow up. We really emphasized that what the DOGE people are messing with at the Bureau of the Fiscal Service is literally the ability to make treasury payments. And in fact, what they're doing is so catastrophic that making treasury payments is kind of the least of the concerns. That'll be the most immediate thing, but like, you know, not getting money in the hospitals, not being able to collect taxes…

It's hard to wrap your mind around this because it's so big, it's kind of beyond a fiscal heart attack. Just, like, making the fiscal machinery of government completely break down. And they clearly have not really understood that they've been messing with that.

And then an added layer, which I started covering around mid-March and had been investigating for a few weeks is that they took $80 million from New York City or they debited New York City's account for $80 million. That kind of might sound complicated, but it's just like any time that you make a credit card payment, you're authorizing your credit card company to debit your account, so you make the payment. All sorts of other debits or credits are authorized by all sorts of actors, but sometimes these debits aren't authorized. Sometimes they're just done without warning.

And normally what happens is, if you do that kind of thing, it's considered fraud and you get frozen out of the payment system if you do it too much. But in this case, because it's the federal government, there's no actor to freeze the federal government out of the payment system once there's a question.

In some fundamental sense, the whole concept of money is making a payment, and then that payment is done. That debt is canceled. You've figured it out. Maybe there's some legal dispute that comes up, and they decide to sue you after. But that's a whole new legal environment. There's no taking it back without going through any legal process unless you're the federal government. And from all the experts I've talked to and some anonymous sources, it seems like there's no guardrail on their ability to just take money out of anyone's account.

That's messing fundamentally with the concept of money. When money is physical cash and I can hand you some dollar bills and then you can walk away, the idea that the payment is final is kind of easier. I have to go track you down, chase you down, have a court case to find you and send some people out there. But with accounts, there's always that awkward question of, can I just take the money back in your account? And we have all sorts of legal and operational niceties that makes that concept go further and further from your mind.

Obviously, there are people who experience these kinds of things already: immigrants before the recent crisis, sex workers, you know, there are all sorts of people at the margins of the financial system who know about how kind of shaky payment finality can be, but it's not a generalized thing in the whole society. It's not, for example, taking money out of New York City's bank account.

And so, connecting it back to the financial crisis is, if you start recognizing that the United States government is undermining the concept that a payment is a payment is a payment and that there's payment finality and that you have the idea that at any moment your bank account can be frozen, debited, anything else, and that you can't really trust having money in the bank, even if it's to deposit insured because the Trump administration is taking the prerogative that they can just take anything from you. If financial markets took this seriously, this would already be like a burgeoning financial crisis.

Paul Krugman: In some ways, I feel like we should be spending all our time on that. But on top of that, we have what looks to me to be a pretty big market dislocation. Nevermind the stock market though I think we both agree that that's not the right barometer but we're looking at bond markets, currency markets and while stuff has been happening and I thought I was ready after 2008 for weird stuff to happen in markets, but now we're getting a whole new level of weird and I've been reading you to try and understand.

So maybe first, just your initial take on what's been happening since Trump held up his piece of cardboard in the Rose Garden.

Nathan Tankus: So we could talk about all sorts of complicated details. And of course, I've written literally 16,000 words on all the complicated details since last week. But in the big picture, the details are just to solidify the basic above the fold take, which is: this is an extraordinary financial crisis because it is a financial crisis, more than any other financial crisis ever, that is directly connected to the erratic and bizarre and dangerous behavior of one person.

And it's not simply the things that he's doing, but the sort of erratic moment to moment decision making. In certain ways, if Trump just committed to causing a depression, if he just committed like, “we're gonna do these tariffs,” and he could credibly commit, to “we're going to cause a depression,” it would, of course, have all sorts of knock-on effects, but we wouldn't have had the financial crisis that we essentially had that, despite a lull, I think we're still in the middle of, because the financial crisis was specifically about the erratic-ness of his decisions.

For younger people on the internet, there's a kind of joke, like, “it's so over. We're so back.” “It's so over. We're so back,” which is just the idea where something bad happens and then you're like, “everything's done.” And then something good happens. You're like, “we're so back. Everything's great.” You know, “we're on top of the world.” And essentially the stock market has been behaving on a “it's so over, we're so back” mindset of just, “Trump is going to crash everything. No wait, the business people are in charge and actually things are going to be okay.”

And they have been trading on that news in this frantic way, moment to moment, where even like a fake headline about Trump backing off on tariffs can, within 15 minutes. create and then take back $2.5 trillion of value on the stock market. And so that's the top line thing: this is a crisis of just Trump's erraticness and Wall Street perceives Trump as somewhat less erratic this week. So the volatility has gone down and so it's not such a crisis. So, if you can believe that Trump will stop, will not be so erratic in the future, then you might be able to believe that this financial crisis is over.

Paul Krugman: And by the way, that's not just financial, it's real. I mean, real investments, plant and equipment investments and so on. Who can make those investments when they have no idea what policy will be a week from now? But the mechanics. Normally you would expect tariffs to strengthen the dollar. Instead it's weakened. Normally we see interest rates go up, but it's been really weird. It's a spike in interest rates. Interest rates should strengthen the dollar, but it's weakened. And then there are lots of individual markets where spreads have widened a lot.

What I learned from you is that the picture we all kind of have of this kind of smoothly functioning financial system is really wrong. You wrote about it, and maybe I should let you talk and try to explain, then I'll see if I can add or just reveal my confusion about all of that.

Nathan Tankus: Yeah. So the way I would put it is: Trump's erratic and bizarre behavior has kind of intersected with a set of longstanding financial regulatory and macro financial issues that a lot of experts have been talking about, at least aspects of, for the last decade. You know, a kind of conversation that was burgeoning in the circles that I run in.

So to back up, we had a great financial crisis in 2007-2008, largely associated with how the banks failed, they didn't have enough capital, and then also there were these sets of liquidity issues.
And so there's a committee called the Basel Committee on Banking Supervision, which is an informal committee, but has developed a lot of informal power, which is basically a meeting of a bunch of financial regulators. The United States, Japan, Europe, coming together to come up with ways to reorganize the financial system. And they've done this a few different times. There was a time in the 80s called Basel I. There was a time in, like, the late 90s, early 2000s called Basel II. And then post financial crisis, we got Basel III.

The big thing about Basel II that a lot of people hammered on was: Basel II tried to focus things on risk-weighted capital requirements. So that's a way of talking about, okay, certain assets are a lot less risky than others, so maybe you shouldn't have to have as much net worth devoted to protecting yourself from losses for safer assets.

Paul Krugman: For listeners, traditional banks take deposits, lend out the money, but we want a bank to have some of its own money at stake, partly as a cushion so that if it takes losses on its lending, it can come out of the bank's capital, partly so that the bank has some skin in the game so that it doesn't take on due risks. And Basel II tried to say, the amount of capital should depend on how risky are the assets you're buying in. And they came up with a scheme for that. So that's really what you're describing.

Nathan Tankus: Yeah. So, to kind of roll that out a little bit, if a bank just got a rubber stamped bank license, like, "Hey, you want a bank license? Let's get you a bank license." And you suddenly had the ability to create money and access the Fed, you make a bunch of loans and then you have assets and you have deposits. And the issue is: if you take any loss whatsoever, then your net worth, your equity (basically just assets minus liabilities) is negative. And for various reasons, this idea of easily getting a bank license only to have your net worth go negative, is not something that financial regulators have ever wanted to incentivize.

So what they do is, they say to someone who's proposing a business plan for a bank, "hey, you need to have some starting out net worth so we know as you're getting going and you're making mistakes and you take some losses, that your net worth is not going to just be negative and that you're not, essentially, just getting to piggyback on the public dime, and so you don't have the ability to just, like, change the world by making loans without anything on your end. So what you do is, you find "investors." You sell them stock. They get this stock and say, "this is a nice stock." And then they pay you money and that money becomes money in your account at the Federal Reserve. Then, on an accounting basis, you're starting out with your assets worth a lot more than your liabilities. And that's great.

And so as you start making loans and so on, then you have that cushion of net worth to take losses. And for kind of obvious reasons, you want to make sure that people don't make so many loans and so many risky loans that they collapse, but they're still able to make a certain amount of loans.

A lot of people showed up and said, "well, it should depend on the riskiness." For example, owning a treasury bill, at least traditionally, forgetting everything that's happened in the last year or the last four months, is a lot safer than making a loan to a local real estate developer. And so why should you have to have the protection of a bunch of net worth against the treasury security the same way as you would for the loan? And so that makes sense a little bit, but the problem is in the details.

The problem is, okay, what is actual risk? How do you measure risk? How do you come up with that? And it's a lot harder and it's a lot easier to game than it seems on the surface. And in particular, what Basel II said was, "We're gonna trust the bank's internal models of risk. And as long as their internal models of risk say it's okay, then it's okay."

And I don't think it takes very much intellectual effort to think of all the ways that that could blow up. And there are all sorts of details about how that got messed with and how that was manipulated to let the banks take on extraordinary amounts of risk without seeming like those risks were there. That's a whole thing on the 2007, 2008 financial crisis. Whole books have been written about that topic.

But for today's purposes, what's important is, Basel III showed up and said, "Okay, we went a little too crazy with the risk weighting. We need to just have a sort of backstop. We need to have, especially for the largest banks, a supplementary leverage requirement. So we'll have risk weighted, but we'll make sure we'll sanity check by saying, 'there's this size of your balance sheet relative to your net worth that you can't go beyond.'" And then at the same time, which we can get into a little bit more, there were all sorts of things that they did on the liquidity side. But that's the big picture. And we'll talk a little bit more about how this has led into the crisis.

Paul Krugman: Yeah, so Basel III set kind of a floor on capital, right? And then we've been operating under that regime. And what did that do?

Nathan Tankus: So, these largest banks at a tactical level, at a corporate level, they're called "bank holding companies." And what that means is, they're not just the nice little chartered bank that has an account at the Federal Reserve. They have all these other subsidiaries that engage in all sorts of different activities. These are really kind of colossal institutions. And traditionally, going way back to the '50s, '60s and such, there was a technical part of the Federal Reserve Act which reached into these companies and limited how much the bank part could support the non-bank parts.

And there's a really under-reported part of the 2007- 2008 financial crisis about this. Saule Omarova, who was Biden's Office of the Comptroller of the Currency nominee, who was a Cornell Law professor, now I believe at University of Pennsylvania, has a really great paper from 2011 that's all about this issue.

And one of the under-reported parts about the financial crisis is: as the banking system was starting to experience issues essentially about making payments, about being able to finance itself, especially on the putatively non-bank part of these bank holding companies, what they started to do was give waivers to these protections to let the bank part finance everything else, to essentially let finance leak out of the bank part to the non-bank parts. And that was their way of trying to keep things on the even keel. Of course, at a certain point it got too big for this kind of maneuver, but what that meant was that post financial crisis, it was like, "okay." When things are hard with the largest banks, they're always just gonna let liquidity go wherever. They're not gonna keep to the original mechanism of trying to keep these things separate. If we're gonna deal with this, then we need to kind of assume that liquidity can go anywhere, that funds can go anywhere within a bank holding company. And so we need regulations on the whole bank holding company.

And so these leverage requirements are on the whole bank holding company. And their liquidity requirements, these requirements of how many essentially "high quality liquid financial assets" they need to have. And we can talk about whether they're actually high quality liquid financial assets, but regardless, they have to hold these in case they need to make payments.

Basically, what this did was, it made these balance sheets quite rigid. You know, on one hand, you have banks that have what are supposed to be liquid assets, that they're unwilling to use most of the time, even during stress times, because the regulations tell them they've got to hold onto these supposedly liquid assets. And at the same time, their balance sheets are kind of rigid now. They can't move up and down the way that they could before, especially for things that were supposed to be low risk. And so this brings us to the treasury market. I don't know if you want to…

Paul Krugman: So, alright. I think where we're going is that with the regulations, in some sense, it's fighting the last war issue. The regulations were designed to limit the risk of a 2008 style crisis. And as I understand it, basically the restrictions on bank holding companies forced or led other institutions to step into the breach. Is that what really is happening?

Nathan Tankus: Exactly. And this kind of gets to the fundamental concept of liquidity.
Liquidity is the idea that: I've got an asset and I can sell it or make a payment at a certain amount, accounted for value. The obvious example is a dollar bill. A dollar bill is a dollar and I can make a payment with the dollar. I can go to my bank and deposit a dollar in my account.
That's not perfect liquidity, but pretty darn good. And same thing with money in my checking account from the perspective of me as an individual.

But there are all sorts of assets out there. There are stocks, bonds, currencies. There are all sorts of assets, and trillions and trillions of dollars of assets. And by virtue of being assets, of being out there, someone has to own them. And if you own them, you have to hold them. And one of the under-commented strengths of the previous system was that balance sheets could expand and contract a lot as you need it, specifically around treasury bonds.

So, okay, however many billions of treasuries that are being auctioned, where people want to sell more treasuries, there's a dealer. There's a government bond dealer that is in a bank holding company saying, "we'll make money if we expand our balance sheet and buy up some treasuries. So we'll do that. And hey people, there's a lot of demand for treasuries right now. Our balance sheet can shrink as we sell off these treasuries and we pay back our liabilities."

And this created a kind of flexibility, this ebb and flow where treasuries were liquid because there was a balance sheet that could always absorb them when they needed to be absorbed.
Someone's balance sheet could expand and take them on. And it didn't require a whole bunch of action from the Federal Reserve because the Federal Reserve could sort of just cultivate these larger conditions. And we didn't really notice that it was really the public backstopping all these things through all these powers that we've delegated.

And the treasury market, it being the "most liquid market in the world" and being stable in that way, was related to these bank holding company dealers whose balance sheet could expand and contract.

Paul Krugman: So I just have a clarifying question. The treasury is just US federal government debt. Are you using it to mean only the short-term treasury bills or are you including the longer maturities?

Nathan Tankus: I'm including all of it.

Paul Krugman: But basically anybody who'd want to sell federal government debt could easily do that, which we took for granted, but was actually because there were these dealers who were basically in the bank holding companies who were the residual buyers who would always step in. But that was then.

Nathan Tankus: Yeah, exactly, exactly. They were the residual buyers. But we still had to deal with this risk problem. To have an absolute constraint on the whole balance sheet, the question became who's going to be the new buyer. And we should say big banks have talked about this.
Like, let's exempt treasuries from leverage requirements. And there's a whole complicated set of debates for why regulators, why good governance types have not wanted to do that. And there's questions about whether it would fully deal with the issue and there's stuff with liquidity requirements.

But putting all that aside, fundamentally, whether or not there was an easy fix on the regulation side, you still need to have a residual buyer. And what has stepped in as the residual buyer has been hedge funds, these types of investors. They find high net worth institutions like pension funds and universities, and they sell them what are called limited partner shares. And basically they're able to go to town and make investments and say, "Hey, we'll get you a good return." And what these entities have been doing in terms of, like, picking pennies off the ground, has expanded their balance sheet by buying treasuries, and they have been hedging themselves, essentially.

So there's a kind of product that institutions can buy that is supposedly safer, especially for those long end treasuries of 30 year, or 10 year terms. And so these funds have become the residual buyer. They have stepped into the void created by a lack of monetary design by the federal government. So something grew up to take on this role.

Paul Krugman: Okay, so until a few months ago, if you were trying to sell US government debt, it would be very easy to do, you wouldn't be disturbing the price. But what many of us didn't realize was that actually it was a hedge fund that would step in and they would expect to be able to unload it but what made the assets easier to sell was the role of the hedge funds, which is a little alarming because people have always worried about hedge funds and whether they might be a systemic risk. And for most of my professional life, the answer was, "well, no, not really." But now you're saying that they're in the middle of the system.

Nathan Tankus Yeah, absolutely. And so people started becoming conscious of this around September 2019. There was a little hiccup, called repo madness, but then March 2020 comes around. In March 2020, the treasury market started to [experience] dysfunction. And it was that moment where people started recognizing this. The Federal Reserve, of course, stepped in and bought trillions of dollars of treasuries. At that time, I was pointing to the fact that we were covertly supporting the treasury market in these previous instances. We were covertly doing all these things.

It's a lot more obscure when the Federal Reserve issues a waiver to a technical regulation from the Federal Reserve Act no one's ever heard of in 2007 than when the Federal Reserve announces in 2020 that it's going to be buying treasuries.

Paul Krugman: So, March 2020, in case people have short memories, that's when COVID starts.

Nathan Tankus: Yes, exactly. So COVID was a period of intense instability, dysfunction, and dysregulation. And in that moment, hedge funds started backing away and the treasury market started to dysfunction. We can talk about why hedge funds started backing away and the kind of problems there. But what I want to emphasize here is that when the Federal Reserve did that, people said, "My God, the interventionist Federal Reserve is borrowing trillions of dollars in securities."

But from my point of view, they were issuing waivers so that bank holding companies could provide whatever funds that the rest of the company needed. This was as interventionist an action from the Federal Reserve to support the Treasury market or support liquidity in these other markets as it would have been for the Federal Reserve to be buying it themselves. It's just that one way is kind of covert. It's sleepy. It's obscure. It's very difficult to understand. And one's kind of direct.

The story is, the Federal Reserve bought Treasury securities, so then they're more liquid because they bought them. It's a thing that people can kind of grasp from maybe a macroeconomics 101 class whereas the kind of sleepy regulation thing is more difficult.
I read a whole law review article about it from Biden's OCC [Office of the Comptroller of the Currency] nominee and that's how I know about it.

Paul Krugman: Alright. So, in March 2020 there was a freeze up in the treasuries market and because the world had become wildly uncertain because of Covid, so the federal reserve stepped in and bought treasuries. But there was a period there when they actually were hard to sell. And basically five years later, almost to the day, we get another seize up, this time not because of a virus, but because of Donald Trump. And what you're saying is that basically hedge funds were not able to do their normal role. I think I know how that happens, but maybe you should spell that out a bit.

Nathan Tankus: Yeah. It's kind of funny to me because, you know, we were talking about Basel II and all that stuff about the risk weighted capital requirements. Well, we kind of have this bifurcated system where we solve the problems for the previous iteration of financial regulations. You know, we solve Basel II with Basel III for banks and for bank holding companies. Or we think we've solved it.

But then it's not like these kinds of risk management practices have gone away. I mean, they're not as bad as they used to be, but fundamentally, at the basic level, it's a lot of the same stuff. The banks in 2005, in 2006, 2007 used value-at-risk models, which is a type of model of trying to calculate risk from historical data, especially recent historical data, to see how risky, how volatile things are, to judge how risky what they're doing is. And so what happens when volatility goes up a lot, the value-at-risk model says, "there's a lot more risk out there."

And then, again, they have that conversation about capital, about financial net worth. You're only supposed to be taking on a certain amount of risk for a certain amount of net worth or a "certain amount of capital". When the risk models blow out suddenly, you're taking on way too much risk for your amount of capital and the risk models are telling you, "you've got to deleverage, you've got to sell assets, pay back debts, shrink your balance sheet."

But remember, the whole point, the reason that the hedge funds have become important in the first place is that their balance sheets can expand when they need to expand. And so this is now creating the classic pro-cyclical situation. Liquidity is there when you don't really feel like you need it, and when you really feel like you need it, it's not there.

Lev Menand, law professor at Columbia, and his colleague Josh Younger, who used to be at the New York Federal Reserve, called them shadow dealers. Shadow dealers are kind of similar to shadow money in the sense that they're providing this treasury dealer role. They're in the market to buy and sell, but only when the times are good. Normal dealers are licensed by the Federal Reserve. They are supposed to always be there in the market. They're always supposed to be bidding on auctions and the privileges that they get are supposed to come with certain responsibilities, and of course hedge funds have none of those responsibilities.

Paul Krugman: So, what's happened now is that you've got volatility. Nobody knows what tariffs are going to be in place three days from now. And that ends up weighing on hedge funds, which feel the need to contract. I guess I would throw in that when you mentioned picking up pennies, I'm old enough to remember long-term capital management, which was a gigantic hedge fund and people always said that their business model was vacuuming up pennies from under the couch cushions on a global scale, and it was great until it wasn't, and then suddenly blew up and markets froze in 1998 when that happened. And you're saying that actually what we're looking at now is something like that happening again except now it's the market for US treasuries that actually is freezing up.

Nathan Tankus: Yes. But the same sort of things are happening in all sorts of different markets that, superficially, you might not see as directly related to the initial thing. For various complicated historical reasons over the last 15 years, a system has been built up where if things get too erratic, liquidity dries up in all these different parts of the system. And there's no balance sheet that is able or willing to absorb what's going on, unless of course it's the Federal Reserve or the Federal Government's balance sheet.

But there's no private sector balance sheet that's willing to absorb the assets that are on there. And where it comes back to Donald Trump. You have a system that works unless volatility goes above a certain level, Donald Trump is the perfect thing to give a heart attack to the system because he is volatility encapsulated.

Paul Krugman: Okay, so it really is these highly leveraged actors out there who are really critical. You're saying it's a market for treasuries and presumably a lot of other stuff as well. I mean, you're seeing spreads blow out on not just junk bonds, but sort of BAA corporate bonds, that sort of thing.

So the new climate of uncertainty basically forces the hedge funds—or high leverage actors, but I guess that's basically hedge funds—to contract and sell stuff. And so you get spiking interest rates even on heretofore the safest assets in the world. For some of us, the fall on the dollar, that's different from March 2020. At that time, the dollar actually went up because America was still the safe haven. So why is the dollar now falling in the middle of all of this?

Nathan Tankus: So, I think there's a few different things there. Before we get to exactly where the dollar is or why the dollar is falling in this situation, what I would emphasize is that liquidity is drying up everywhere. When I say everywhere, I mean everywhere.

Liquidity in, like, essentially currency trading. The foreign exchange market also kind of seized up last week. There was an article in risk.net that said liquidity in the foreign exchange spot market was worse than during COVID. Some of these same things happened in COVID, but this happened more. And the article says that relative to the period leading up to this, volatility within a day (financial market participants use the phrase "intraday" for that) but volatility went up more than five times.

And so that volatility explosion is really the thing that's important in the foreign exchange market. Suddenly you really need to have big, big price movements where some entity with a balance sheet decides to step in and absorb some position or another.

This also connects up to the last 15 years. These things are called foreign exchange swaps.
There's the type of derivative where you swap one currency for another, you swap yen for dollars, and then it'll go back the other way. You'll swap it at a different price at some time down the line—a week, a month, three months, whatever. And these have become the kind of focal point of the financial system.

As of June 2024, there was $113 trillion worth of foreign exchange swaps out in the world, which is a mind-numbing number. The vast majority of that had dollars on one side. 87% of those swaps involved

dollars, which is a truly astounding amount. Dollars are so important to this system that generally speaking, when a Japanese bank wants euros or a European bank or a British bank wants yen, they don't just swap. The obvious thing would be to swap yen for euros.
Instead, they first swap yen for dollars and then swap dollars for euros. The dollar serves even as an intermediary between Japan and Europe, it's so central in these foreign exchange markets.

Paul Krugman: Yeah. We call it the vehicle currency and it's what you take to get a ride from one currency to the other. But that role depends on dealers and the dealers need liquidity.
Wow. Okay.
So what you're saying is that all the foreign exchange markets, presumably corporate bond markets, treasuries, all of it depends upon liquidity supplied largely by hedge funds.

Nathan Tankus: Yes, in our current system. But also foreign hedge funds. It's not just that domestic hedge funds have pulled back. It's also that there are foreign hedge funds. And this is where these foreign exchange swaps come in. I wrote a piece a couple of years ago called The Utopian Vision of Financial Derivatives, and what that piece was getting at is, if you're an ordinary person you might think lending to a New York real estate developer or lending to a regional Japanese government or lending to a British oil and gas company, that these are all different things.

But if you have a certain kind of lens, if you see the world through a certain set of rose-tinted glasses, all the financial market participant sees are different kinds of risks that can be mixed and matched. And I can turn any of those assets into a kind of treasury bill. I've just got to buy the right derivatives. So if I'm worried about them defaulting, then I can buy a credit default swap, which is just insurance against default. If I'm worried about the interest rates moving in a way that's bad for me, I'll buy an interest rate swap.

And so you can sort of just construct any sort of asset you want. And this works as long as you don't have to worry about actually getting paid by the other person who has your derivative. And this of course was the big thing in the 2008 financial crisis. The insurance giant AIG took one side of all of those credit default swap bets and then couldn't pay up. And then the federal government had to step in.

But even putting aside the counterparty stuff, there's also just this basic question of liquidity. My model says that when this certain event happens, the value of this asset will go down. But the model says the derivative should go up just enough to offset it. And so I haven't actually taken any loss. But the problem is, you don't actually know what's going to be happening in the liquidity, whether the model value will line up because of things that can be going on in the world. For example, liquidity drying up everywhere. And there's no such thing as a private sector liquidity swap. And of course, even if there were, the obvious question would be: who guarantees liquidity for the liquidity swap?

And so ultimately, what happens is, there are all these investors who make decisions based on the idea that risks are just all swappable and they can get whatever kind of portfolio that they want with these products. And then it doesn't work in crisis times.

Paul Krugman: Okay, and so we get this possibility that increased volatility means that the people who supply liquidity kind of go away, which means that all of these investments that were supposed to be safe or at least limited risk because you had derivatives start to become really problematic. So that's what you think is happening now to the markets.

Nathan Tankus: Yeah, when volatility goes down, it gets better. But volatility is elevated if you look at things like the VIX, which is an index everyone relies on. It has gone down some. So things are kind of a little bit calmer right now, but they're still quite elevated compared to what they were before all this started. With other financial crises, there's all sorts of financial indicators that you can look at to judge whether a crisis is gonna get more severe. The issue is, because everything is just related to volatility and the volatility in this situation is just related to Trump, there's no real financial expertise that can tell you exactly where this is going. It's like, you just need a psychologist. You need someone who's somehow an expert in Trump's mind palace or the people around Trump and how they can manipulate him (or not) to judge whether volatility is going to explode next week or whether it'll settle down and he'll just, you know, flip channels and not get so focused on the news that week.

Paul Krugman: Yeah. So what's strange is that it's not even so much the level of tariffs. It's the fact that you don't know what they're going to be. We had one radical break in the tariff regime on April 2nd and then it zipped in a completely different direction on April 9th and then another big change on April 12th. And that's what's really the problem.

Nathan Tankus: And that's why I said the financial system would do a lot better if Trump just committed to creating a depression. Then you'd be like, "okay, he's going to raise tariffs a lot.
He's going to stick to it. It's going to cause a global recession. But we know it's going to cause a global recession." The volatility now has been about trying to predict what will happen. And all the back and forth. And those huge swings between "the economy will be fine" vs. "a depression is coming" is what's interacting with these extant vulnerabilities in the financial system.

Paul Krugman: I would say it's not clear you would be causing a depression if the policy were stable. If we just had 25% tariffs. And everybody knew that was stable, then that would be a bad thing, but business would work with it. And it's not known whether they're 25% or 10% or 100%. That is the problem.
All right. In 2020, the Fed just stepped in and bought lots of treasuries. Is there a simple technical fix to this one? Why doesn't Jerome Powell just step in and rescue us from all of this?

Nathan Tankus: Well, there's a couple things. We're talking about it kind of happening everywhere, and it kind of did happen everywhere in 2020, which is why there were all those other facilities around corporate debt, around municipalities and so on.

Paul Krugman: So these were not just treasury bonds. I didn't even know that. I'm embarrassed, but they did a bunch of facilities for other markets as well, not just buying Treasuries?

Nathan Tankus: Yeah, absolutely.

Paul Krugman: Okay. So, sorry, go on.

Nathan Tankus: And so, they can step in on the liquidity issues. They're still worried about inflation and the tariffs are bringing up the question of inflation even more. So it's kind of a full spectrum thing. They probably wouldn't do it unless things got really, really bad. But, I would expect, if the treasury market had gotten too chaotic for them, I think they would have stepped in. And I think ultimately, even if there's some awkwardness between some of the things that they had said coming into this crisis, they would do that. And it would basically be fine.

The problem is, you know, in 2007, 2008, the volatility was about financial instability and recognizing the financial instability. So stepping in to stabilize financial markets could slow down or make the volatility go away. But, you know, Jerome Powell can't make the volatility of Donald Trump go away.

And the Fed, for various reasons, both political but also kind of practical, wouldn't want to try to do a big audacious step in to deal with all the dysfunction related to Trump being unstable. I think if you ask them at a press conference, it would be like, "Well, it's the president's response.
The president is making a certain amount of decisions and he is pursuing a certain amount of economic policy and it's not our role to countermand him. And so if he wants to create a whole bunch of instability for his own reasons, that's essentially his business and we'll be concerned and we'll look at all the markets. But, you know, we hope there's a resolution to this and yada, yada, yada."

So, doing a whole bunch of things probably wouldn't work that well and would also be stepping into the void or getting in the middle of this very charged political set of issues. As long as the Treasury can still make payments, they can let Trump get to a certain point and see if there's kind of a resolution to this situation. The Fed doesn't want to be involved with this at all, or as little as it can. They would prefer there to be a political resolution.

And you kind of see similar things at a much lesser scale around the debt ceiling crises, where they've tried to really step out of the way and see it as a political issue to be resolved and only step in if they think something is irreversibly broken or if that seems like it is about to happen.

Paul Krugman: Okay, I'm not sure if this is a devil's advocate argument or not, but is there kind of a floor on how bad things can get? Because if the Fed steps in with facilities to address these kinds of balance sheets, and all the volatility contagion, if it's bad enough, they can always make sure that there is enough liquidity. They are essentially the buyer of last resort for a lot of assets.

Nathan Tankus: Let me think about that. I think to a certain extent that's true, but only for short bursts. There's just a certain level of volatility where some of these non-bank financial institutions will blow up. I really think we were close to that Wednesday. I think if he had not backed off, if he had waited another day, we easily could have had a firm or multiple firms blow up and go down. And that's why I brought up Lehman Brothers in one of my posts. I saw it as that serious and frankly, I was trying to be one of the voices to be, like, "Hey, this is a Lehman moment. So back off and, you know, try not to blow up a number of firms."

And I definitely think there is a level of volatility and a duration of volatility, like a set of days where, beyond that, we would see multiple firms blow up. And then there's also a question of international firms blowing up. And then of course, that brings up larger questions about the dollar. I think it'll be weeks, months, maybe even years before we fully understand just how close we came. And there's a lot of people who are keeping their cards very close to the vest because you don't want to say that your firm was, like, 24 hours from blowing up or whatever.

But I think we're going to learn more extraordinarily alarming things about last Tuesday, last Wednesday than is currently acknowledged.

Paul Krugman: Just for time reference, April 2nd was the first big tariff announcement. And that was a Wednesday. Weeks ago. And then basically a week after that, we were pretty close to the edge of a of a post-Lehmann style financial crisis. And then Trump announced a different set of tariffs that were actually, overall, maybe just as high, but different anyway, and were perceived as a step back from the brink.

And so you were saying that the financial system stepped back from the brink, but not that far.

Nathan Tankus: Yeah. And volatility is still elevated. And this kind of goes back to the piece I put out the Tuesday before last, so I guess that's April 8th, which talked about the stock market. These kinds of markets are conventional wisdom processors. That's kind of a reference to Friedrich Hayek and the idea of markets as an information processor. It's a little bit of the same thing but something different. The idea that they're conventional wisdom processors is that there's a general idea among a certain rarefied group of people who are the most active participants in these markets and what is conventionally believed among them is really what drives things, not access to information that any group of people have. Or a consensus among a different group of people.

The stock market would change very differently if suddenly, a week from now, all the major stock traders were scientists. What they would price in, especially around things like climate change, would be very, very different from the current set of participants. So it's important. The way people talk about markets is that there is an objective measure. That they just take information from everywhere and process them. But really, it's a specific set of people.

As I say in that piece, you would have to have a specific mindset and be a specific person in the world to believe that Donald Trump would be better for the stock market than Joe Biden. To believe not only that Donald Trump would be good for the stock market, that he'd be so much better than having four years of Kamala Harris or whatever, that you can track the odds of Trump winning with the stock market going up when Trump's odds of winning were going up.

Like that's a particular kind of worldview. You know, people that we don't particularly like, people that we think were kind of nuts might have said that. And of course, not everyone on Wall Street believed that, but enough people believed it on Wall Street that it was taken as a conventional wisdom.

It's not something that you should sort of fight against when you're trading stocks and trading in other financial markets. And that's a uniquely dangerous situation because that kind of person is the kind of person who's going to look for any off ramp, any sort of little sign that things are going to be better. And so when the stock market went up a whole bunch after Trump's announcement and volatility pared back some, it's not so much that these are more protectionist tariffs, at least as of last Wednesday—Of course, it's changed even more in the week since then. It's not like they were great, but it was just a headline in the news that would make people say, "My God, Trump is backing off. Okay, good."

And what matters is not so much the reality of this thinking, but how different factors interact with each other. And the media apparatuses present a general mood that comes from a certain perspective. It's so much that Trump needs to actually back off on tariffs or needs to be doing sane tariff policy, it just needs to be perceived as not crazy by these specific kind of idiosyncratic groups of people.

Paul Krugman: Which does raise the question, if he really is going to be crazy, eventually that will filter through. So to some extent we may be getting a reprieve because the conventional wisdom is, it's really not so bad. But just to say, it took about two hours for people in my circle who actually were doing the tariff numbers to see that these new tariffs are basically the same overall tariff. It's the same average tariff rate as before.

They're different, but they're just as bad. The market treated it as a major step back from the cliff. And so that was all that mattered in the moment.

Nathan Tankus: Yeah.

Paul Krugman: It may be motivated reasoning because of the politics, but I'm worried that there is another shoe to drop, that even now markets have not really processed just how unstable things are. Sounds like that's your sense.

Nathan Tankus: Yeah. It beggars belief that the tariff policy is not gonna pick up instability and that Trump is not gonna pick some crazy fight where you get into this back and forth between, "is he gonna do it? Is he not gonna do it? Is he gonna do it?" So I think that kind of episode is gonna happen.

The other thing is just what we started with, the main thing that I've been focusing on, what I've been calling the Trump-Musk payments crisis. The impoundment issues and just sort of taking seizure of the federal government. People used to talk about political risk being part of what gets priced in. Well, there's an enormous amount of political risk in the United States right now.
And then there's the further point where they're in the process of claiming that they can take money out of anyone's bank account or freeze anyone's bank account. It's actually mind-bending trying to keep up with these stories of all the different ways that they're going after bank accounts. I mean, they froze a New York state government bank account related to EPA grants that were already handed out that were being administered by Citibank. And I want to dig into that more and write about it more. But that's just one of, I would say, four or five different payment stories that are calamitous.

Let alone their wanting to move social security off of COBOL, which we talked about. They want to do it within two to three months, and they want to use AI to do it. I mean, that is an existential threat to social security existing. That's a cockamamie plan. And I don't know what the current state of it is. I've been focusing on the financial crisis, so I need to get back into it. But I don't even know how to articulate how insane a disaster this is. And hey, there's a lot of financial risk if social security breaks and no one's getting social security checks.

And these kinds of risks are just like a dime a dozen right now, all across the administrative state. And then there are other layers, forgetting even geopolitical things like, are we invading Greenland? Maybe? All of these things are just so enormous.

That's why, you know, I didn't think I would succeed, but why in that first week of the Trump-Musk payments crisis, I was pretty conscious in that Odd Lots interview on Bloomberg, to try to really hammer home just how potentially calamitous this is to the financial system and explicitly say that all these financial markets should be pricing in these kind of uncertainties and they are not doing so.

There are now questions that are burgeoning up on the dollar. I wrote a gigantic monster of a piece about that on Sunday. I'm going to be writing some more big picture things about the dollar this week, but to me, the real question of a disaster, of a crisis, is when these people who suddenly have started to lose faith in the Trump administration's economic policy, that they start looking around and looking for other eventualities. They look at other things that are threats to the dollar, and come across the panoply of things that I've been covering and put two and two together. If this payment system goes down, the whole fiscal machinery that makes the dollar the dollar is gonna collapse. And then that could potentially be a second wave of the financial crisis.

But I don't know whether to put it as a bright side or a negative. And right now I'm kind of more inclined to see it as a negative but, even when something is kind of slammed in their face, like Trump's tariffs, they didn't really get the message until he had to slam their faces into the pavement a few times.

Something like the Trump-Musk payments crisis, it's the kind of thing where, as Joe Weisenthal said at the end of that interview, financial markets will only freak out when something actually breaks. But we can't wait for something to break. That is too dangerous. That's too calamitous.
They'll show up and say, "man, this problem is so bad," when the building's already burned down and is in a cinder.

Paul Krugman: Maybe we should leave it there. I need a drink.

Nathan Tankus: Well, let's get that drink.
Last thing I wanted to mention, and this is also a sign of how bad the crisis is: My lease on an office in Manhattan started yesterday, 2,000 square feet. And so, for listeners who want to support that kind of effort, make sure that that venture is a success, kind of expanding notes on the crises into a bigger deal, you know, please take out a subscription, send a tip. Everything helps right now as I expand out my reporting and bring on some really amazing people to contribute to do some of the things that I've been doing on different topics.

Paul Krugman: Okay, we're gonna need it. So good luck and hope that DOGE doesn't freeze your payment for the office space.
Okay, thanks for coming on.

Nathan Tankus: Of course.

Paul Krugman: I'm sure that you will have plenty of work to do, alas.

Nathan Tankus: Yes, unfortunately. I'll have to go visit my office.

Paul Krugman: Take care.