Where Should We Go From Here? Inflation, Regulation, and Debt

Warren Coats
Macroeconomic policy in the United States faces major challenges in three broad areas: a) unwinding massive financial sector liquidity support to maintain price stability without undercutting the real economy’s recovery; b) strengthening financial sector regulation without undermining financial sector efficiency; and c) reducing actual and projected fiscal deficits sufficiently to contain the national debt as a share of GDP.

Inflation

The Federal Reserve responded quickly, vigorously, and imaginatively to supply financial markets with their large increase in demand for liquidity following the failure of Lehman Brothers and rescues of Fannie Mae, Freddy Mac and AIG. In the face of a huge increase in market uncertainty about the value of many mortgage related assets and the soundness of market counterparties, interbank lending froze up. The Fed’s usual primary dealer channel for distributing central bank funds failed and the Fed opened new channels for lending to a wider range of financial institutions. The size of the Fed’s balance sheet more than doubled in a few months. The Fed’s bold actions helped prevent a total financial melt down though credit markets slowed considerably.

The first chart below depicts this dramatic increase in the Fed’s monetary liabilities, the so-called Monetary Base, which provides the basis of the growth in the broader money supply (the public’s holdings of currency, bank deposits and money market mutual funds). The second chart presents the same data as the percent change from a year earlier. The picture revealed is that the growth rate of the monetary base has fallen almost to normal rates, but that the level still remains highly elevated.

The second pair of charts presents the level and the year on year rate of increase for a popular measure of the money supply. The money supply did not increase nearly as much

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as the Monetary Base because much of the increase in the Base was to satisfy an increase in the banking system’s demand of liquidity and did not increase lending and the money supply to anything like the same extent (see the chart on total bank lending). Again the picture is of a return of monetary growth to normal even below normal rates, while the level remains modestly elevated.
The Fed’s monetary policy has two primary challenges if it is to keep inflation in the 2 to 3 percent range. First, it must unwind the large increase in its balance sheet (the Monetary Base) as banks return to more normal levels of liquidity so as to prevent the high level of the Base from increasing the money supply too rapidly. To a lesser extent
the Fed must also withdraw or slow the growth in broad money as the public’s demand for it returns to more normal levels. The public has demanded higher than normal levels of money as it also sought greater safety and liquidity. As the public’s demand falls back to normal levels, the Federal Reserve’s supply must fall as well in order to avoid inflation. It will be difficult to get the timing just right, but there are no technical reasons that the Fed cannot reabsorb the extra liquidity it created in an orderly way without increasing inflation. The Fed’s second challenge will be to resist the political pressures to keep interest rates low and thus cause the money supply to grow too rapidly as they rise with the economy’s recovery and the government’s large deficit financing needs. More on that later.

![Total Loans and Leases at Commercial Banks (LOANS)](source: Board of Governors of the Federal Reserve System)

### Regulatory Reform

The financial sector has become too leveraged and taken on too much risk. In the mortgage area government pressure to lend to more and more risky borrowers fed a presumption that the government would help out if loans went bad. The government’s erratic and unpredictable response to financially distressed financial enterprises, especially those “too big to fail,” undermined market discipline of bank behavior and fed the appetite for excessive risk taking by banks dominated by traders rather than traditional relationship bankers. Both lender and borrower behavior has been infected with moral hazard—taking risks for big profits in the expectation that others (tax payers) will cover any losses.

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The most recent crisis might be divided into those aspects unique to the real estate market (the housing price bubble) and those concerned with the workings of financial markets in amplifying the distresses that originated in the housing sector. In seeking to correct the government’s social and regulatory policies that contributed to or aggravated the crisis, congress and regulators should be guided by the goals of relying on market allocation of financial resources, while limiting the risks taken with depositor or borrowed many. Policy should seek to find a balance between the market’s incentives and freedom to innovate, i.e., to development new economies in the allocation of saving, and in mitigating and/or limiting risks. Market discipline of risk taking should be enhance by improved transparency, and regulatory discipline should operate primarily via requiring financial enterprises to hold sufficient capital in relation to the risks they take, and enforcing honest accounting standards and reporting. Stricter regulation should be applied to commercial banks – the deposit taking institutions that provide the core of our payment systems—to counterbalance the moral hazard to take risks with depositor money that is created by deposit insurance and to protect the integrity of our core payment systems.

To a large extent, risk adverse investors are forcing the market to clean itself up but that will not be quite enough. The legislation now being discussed in the Senate runs to over 1,400 pages. I can only imagine what might be there and the substance is changing daily as the Senate works through hundreds of amendments. The details make all the difference, but the major issues concern the treatment of large, “too big to fail” financial institutions, the organizational structure of supervision, regulation of financial derivatives and corporate governance.

**The mortgage market**

Cheap housing finance (because of a world glut of savings and a large supply of it for housing via securitization) and government pressure to extend home ownership to marginal borrowers drove underwriting standards down and prices up.

Mortgage underwriting standards need to be strengthened. Require at least a 10% down payment for any mortgage that is securitized and a reasonable expectation that the borrower will be able to make the required monthly payments over the lifetime of the mortgage. The enforcement of these standards needs to be strengthened. Mortgage originators need to keep some “skin in the game,” e.g., retain at least 5% of any mortgage they originate, in order to have a financial stake in loan quality. The market will tend to do these things on its own, if the government doesn’t interfere with the likes of the Community Reinvestment Act and Fannie Mae and Freddie Mac.

The Government Sponsored Enterprises—Fannie and Freddie—need to be cleaned up, properly capitalized, and privatized with a purely commercial mandate. Alternatively,

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they could be slowly liquidated over the next five to ten years. Social policy should be administered through government agencies such as the FHA.

Bailing out underwater borrowers should be undertaken very cautiously. It is not easy to distinguish between borrowers speculating on housing prices, those who were reckless and imprudent, and those with bad luck (e.g., falling ill and/or losing their job). The risks of moral hazard apply to borrowers and lenders alike.

**Financial markets**

Securitization instruments need to be less complicated, more standardized, and less leveraged. Capital standards for financial enterprises need to be brought more in line with actual risks taken. This is particularly important for banks, which now finance a lot of the leveraged investments of hedge funds. Bank should not be allowed to hide their risks off balance sheet. For banks that operate internationally these standards need to apply internationally to preserve a level playing field. Paul Volcker’s proposals for limiting trading activities and other narrow bank proposals deserve serious consideration to preserve the safety and soundness of our core bank based payment systems.

Market discipline of financial behavior needs to be restored and strengthened by reestablishing clear rules for entry and exit. Many earlier weaknesses in market arrangements and instruments have already been corrected by market participants who want to know the risks they are taking in the pursuit of profits. Government policy was erratic and hard to predict in 2007-8 with the bailout of Bears Sterns, and AIG and the bankruptcy of Lehman Brothers. No firm should be too big to fail.\(^4\) This goal should be made realistic by adopting resolution/bankruptcy legislation that is realistic enough to actually use when a financial enterprise becomes insolvent. In addition, regulatory incentives should discourage financial enterprises from becoming so big that their failure might raise systemic concerns. Each of these is considered in turn.\(^5\)

**Too Big to Fail**

In order to make the replacement of bailouts with resolution (sale in whole or in part, liquidation, etc) a practical option, both the Bush and Obama administrations asked Congress to extend the administrative resolution tools of the FDIC for banks to systemically important non bank financial institutions. Failing or failed bank resolution is administer by the FDIC in place of judicially monitored reorganization or liquidation applied to non-bank companies by the company bankruptcy laws. Traditional judicial bankruptcy procedures for insolvent corporations were rarely applied to banks around the world for fear that tying up depositor funds pending the liquidation of assets over periods of years would be too disruptive to the financial system. Banks were almost universally bailed out instead. America’s administrative resolution of banks made the process more efficient and thus easier and less disruptive to use. Potential abuses of the FDIC’s broad,

\(^4\) Warren Coats “Too Big to Fail Doesn’t Cut it Anymore,”
http://dailycaller.com/2010/02/03/too-big-to-fail-doesnt-cut-it-anymore/

\(^5\) The next three paragraphs are quoted from Warren Coats “Give Bankruptcy a Chance.”
http://dailycaller.com/2010/03/05/give-bankruptcy-a-chance/
administrative resolution powers are limited by the requirement that it adhere to the least cost approach (to the insurance fund and ultimately to taxpayers) to resolution in each case.6

In an effort to overcome the propensity of regulators to delay taking action, and the cost of such delays, congress passed the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991, which mandated the resolution of banks that became “critically undercapitalized” (below 2% of assets) and provided a mandatory escalation of structured remedial measures as a bank’s condition deteriorated toward insolvency. For over a decade FDICIA restored strong market discipline of bank behavior. Virtually no banks failed during that period because they took the measures needed to remain well capitalized and avoid excessive risks in order to avoid the FDIC’s intervention.

More recently this sterling performance has deteriorated. Not only have regulators (OCC, Fed, FDIC, etc.) failed to collect and analyze data that would be relevant for assessing and monitoring the potential systemic risks of various financial instruments and practices and responded to failures inconsistently, they have intervened later in the process. As a result the costs to the FDIC of its interventions, which should be zero if undertaken as soon as a bank is critically undercapitalized, have increased. The FDIC suffered larger losses in its recent resolutions than was normally the case in the 1990. The “Prompt Corrective Action and Structured Early Intervention and Resolution” requirements of the FDIC Improvement Act of 1991 (FDICIA) have apparently not been as rigorously adhered to as they were earlier.7

The key policy question in this area is whether similar “open bank” administrative resolution tools should be extended to non-bank financial enterprises. The Administration has proposed legislating such powers for firms judged too systemically important and interconnected to be allowed to fail via normal bankruptcy. A council of regulators would designate the firms—thought to be on the order of 20—that would be liquidated using such tools if they became insolvent. Stockholders would lose all but most creditors (bond holders, depositors, etc.) would be bailed out.

The Chapter 11 bankruptcies of GM and Chrysler raise concerns of the potential for political interference with the bankruptcy/resolution process, especially if FDICIA administrative resolution powers are legislated for systemically important financial institutions. Union pension funds received a better deal than did secured creditors contrary to normal bankruptcy law. Such arbitrariness undermines sound investment decisions and beneficial market discipline of behavior. Rather than the administrative resolution powers in the Dodd bill now working its way through the U.S. Senate, I lean

toward amendments to judicial bankruptcy law to accommodate the special features of financial firms including the conversion of bondholder positions into equity in the event of insolvency where Chapter 11 conservatorship seems appropriate. All large financial firms should be required to develop “living wills” describing how they could be liquidated in an orderly way. The key in this area is to restore market discipline by wiping out shareholders and a reasonable number of creditors (bondholders) when financial enterprises become insolvent (or critically under capitalized) while saving the rest (e.g., depositors) to limit the risk of contagion. With the right balance between these, bankruptcy becomes an effective tool that will actually be used predictably.

While the government should have the tools needed for an orderly resolution of all firms no matter how large, capital standards and other regulations to limit risk taking should counterbalance the artificial benefits of growing so large that the market comes to believe a firm is too big to fail. Such regulations would result in better market pricing of risk and thus limit the extent of risk taking more in line with the economic benefits. These artificial inducements to excessive size would thus be removed or reduced, thus discouraging financial firms from growing too large in the first place. The restrictions on the business activities of banks proposed by Paul Volker also deserve serious consideration.

To be effective in our global market, such regulations need to be applied on a global basis through the capital and liquidity standards adopted by the Basel Committee on Effective Banking Supervision in order to maintain a level playing field for American and foreign banks. I am optimistic that the Basel Committee will produce such standards by the end of this year.

Reorganization of Regulators
The Dodd bill now being debated in the U.S. Senate goes part way toward streamlining the organizational structure of financial sector supervision in the U.S. It combines the Office of Thrift Supervision with the Office of the Controller of the Currency (OCC) and moves the responsibility for supervising state chartered banks from the Federal Reserve to the OCC. The Dodd bill should go further. The Fed should be stripped of all supervisory authority in order to focus fully on monetary policy. To fulfill its lender of last resort function the Fed only needs information on the conditions of banks. It can obtain this without having any regulatory or supervisory authority. However, it now seems likely to keep all or most of its current supervisory functions.

Derivatives regulation
Derivatives—from the relatively simple commodity and exchange rate futures, interest rate swaps, and mortgage backed securities (MBS), to the more complex Collateralized Debt Obligations (CDOs), synthetic CDOs and Credit Default Swaps (CDS)—have made raising capital and distributing and managing risk more efficient and hence cheaper. But as we have seen, they have not been without problems and have sometimes been over used. Some have become too complex for their own good, largely benefiting the investment banks that earn large commission for putting them together. It is sometimes difficult for investors to know what the underlying assets are that determine the market
value of complex derivatives. This adds to market uncertainty reducing the liquidity and increasing the volatility of the prices of these instruments. The net exposures of individual players are also not well known, making it difficult to impossible for regulators to assess any potential systemic risks.

Take the synthetic CDO made possible by the use of Credit Default Swaps to short the mortgage market that got Goldman Sacks into trouble. CDSs on mortgage instruments were only introduced in mid 2007. The timing couldn’t have been worse as they accelerated the decline in the market value of such instruments. If they had been around a few years earlier—say 2003—the ability to bet against the rapidly expanding subprime mortgage market would certainly have greatly reduced the crazy excesses reached in that market. However, the over exposure of AIG to CDS with little to no collateral because of the AAA rating of its main insurance business, might have brought the company down if the government had not intervened. No regulatory body was aware of AIG’s huge exposure and as it was struggling to meet growing margin calls no regulatory body had the data needed to evaluate the risks of letting it fail. “The AIG Financial Products division headed by Joseph Cassano, in London, had entered into credit default swaps to insure $441 billion worth of securities originally rated AAA.”

Credit Default Swaps are useful financial instruments, but their use and the exposures of those using them need to be made more transparent. Greater standardization of contracts and listing them or even trading them on central exchanges should go a long way toward limiting the risks of abuse. Exchange trading of CDSs in which the exchange establishes and enforces collateral requirements and becomes the counterparty to every purchase and every sale would greatly reduce counterparty risk and interconnectedness. Creating a database of all mortgage backed securities and the mortgages they include with up-to-date data on their payment status would greatly improve market confidence in the proper value for such assets, which would increase their liquidity and reduce risk premiums and price volatility. Data on individual firm exposures to all relevant financial instruments should be collected and available to regulators and the public. In general, measures to make financial markets more transparent and to limit the complexity of some instruments (something the market has already done on its own) are welcomed.

**Corporate governance**

Until 1999, Goldman Sacks, like virtually all investment banks, was a partnership. In 2008 it became a bank holding company in order to have access to the Federal Reserve’s lending facilities. The partnership ownership structure reflects more closely the traditional textbook characterization of self interested capitalists carefully managing their firm’s resources to maximize its value over the long run. Public ownership has weakened owners’ control of their firms’ managements. Since the repeal of Glass Steagall Act in 1999, the managements of most of America’s largest banks have been taken over by investment bankers and/or traders whose taste for risk taking is very much greater than that of traditional relationship bankers. Under the potentially wide spread ownership by

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8 Warren Coats, "Goldman Sachs and Their Kin", The Daily Caller, April 26, 2010
9 Wikipedia “American International Group”
shareholders of publically traded companies, the issue arises of how well owners control the behavior of company managers. Such control is exercised through the boards of directors elected by shareholders. Shareholder control over the appointment of directors needs to be strengthened, as does shareholder control over remuneration, including bonuses, of management.

**Consumer protection**

Borrowers need to be better educated about the choices they have. The government can play a useful role in improving public understanding of borrowing options and risks. Some lender practices, especially credit card issuers, are shady and should be restricted. But in generally greater meaningful transparency should be the goal of consumer protection. By “meaningful” transparency, I mean presenting rules, penalties, and financial consequences in a simple understandable fashion. I would rather expand the coverage and mandate of consumer protection powers of existing regulators than create a new agency (or autonomous unit within the Federal Reserves), but I think that that battle has been lost.

**The Debt Bomb**

The National Debt of the United States Federal Government as a percentage of its Gross Domestic Product (GDP)—a measure of its capacity to service its debt—fell from 120% at the end of World War II to about 35% in 1982. This heartening decline resulted from the reduction and occasional elimination of the government’s annual deficit (the annual addition to the outstanding debt) and growth in GDP (the denominator of the ratio). The Federal government’s tax revenue fluctuated around 18 percent of GDP during most of the post WWII period and the average annual deficit was 1.1 percent between 1950 and 1982. GDP grew 7.8 percent per year on average over the same period (3.6 percent of which was real and 4.2 percent of which was inflation). Thus the rapid and steady fall in the ratio of the debt to GDP reflected the low annual deficits and rapid economic growth over the period.

Since 1982 the debt ratio has risen steadily (except during the Clinton Presidency during which government spending as a share of GDP declined) to 83% in 2009 and is projected to rise to an astounding 94% this year. In dollar amount the gross federal debt is now $12.4 trillion ($113,194 per tax payer). The Congressional Budget Office base line forecast projects that this amount will increase by $8.5 trillion to $20.9 trillion by 2020. This does not include the huge unfunded Social Security and Medicare liabilities of over $99 trillion that will need to be paid for in the future. The Federal debt is projected to exceed 100 percent of GDP within two years.

The failure to address this problem, i.e. the failure to limit the growth in the debt to or below the growth in GDP, reflects the unwillingness of those who want government to do more to cut spending (generally Democrats) and of those who want government to do less to raise taxes (generally Republicans). Combined with the political reality that it is easier for our representatives to increase rather than reduce spending and to lower rather than increase taxes, our political system has been biased toward deficit financing.
Many supply-siders seeking to promote investment and more rapid economic growth with better (i.e., more neutral) and lower taxes, also tried to use tax cuts and deficits as a tool to restrain government spending. It hasn’t worked. Rather than restraining spending, deficits simply got larger. The idea that we can “Starve the Beast” by forcing government to borrow if it spends more has been convincingly challenged by former CATO Institute Chairman William A Niskanen, in the Cato Journal 26 No 3. There is also a lot of evidence that taxing the rich to pay for larger government, an approach favored by some Democrats, would reduce investment and growth, thus undermining the goal of reducing the debt to GDP ratio through growth in GDP.

Greater honesty here would be helpful. As a society we need to decide what we want the government to do (the size and nature of government) then pay for it with the most economically neutral, efficient and just taxes possible. There should be no fiscal deficits on average over the business cycle. The optimal size of government is both an objective economic issue and a political one. The size of government in the U.S. (Federal, State, and local) has averaged around 35 percent of GDP from 1955 to 2007. Federal government expenditures over that period fluctuated around 19 to 20 percent. In the current year Federal government spending is projected to rise above 25 percent of GDP, well above the norm. Outside of the Civil War and WWI, Federal government spending did not rise above 5 percent of GDP until the Great Depression and WWII, never to return.

Greece illustrates the ultimate consequences of failing to live within our means. Even at the level of the Federal government’s gross debt of $14 trillion projected for this year (projected to double in 15 years), a one percent increase in the interest rate on the government’s debt ultimately increases the annual interest cost to the government of that debt by $140 billion. As the economy recovers interest rates on government debt are
expected to increase 3 or so percentage points or an increase in government interest payments of $420 billion per year. But as credit conditions in the U.S. and around the world tighten, an addition one or two percentage points could easily be added to interest rates to attract the funds the government will need, which would eventually increase the Federal government’s interest expenditures by $700 billion per year on top of the roughly $500 billion per year already being paid now. Such an amount would be almost 20% of this year’s federal budget. However, if the market comes to doubt the ability of the government to meet these commitments, as was the case in Greece, the market will demand an additional risk premium to lend to the government on top of prevailing market interest rates. This premium for Greece was over 6 percentage points, which could more than double the additional interest cost of the existing debt and we haven’t begun to take account of the increases in the debt that is projected for the coming years. Much of our debt is held abroad. Even if China and others were willing to continue holding the 4 plus trillion dollars of our debt they now own, their unwillingness to buy still more by itself would cause the exchange rate of the dollar to plunge internationally. At some point the market would stop lending to the government altogether and the U.S. government has no one large enough to bail it out.

Data compiled by Christopher Chantrill, USGovernmentSpending.com

Everyone knows that we have a deficit problem but neither side has been willing to yield in a political game of chicken. All of us, the whole world, will be the losers if a bargain is not struck soon. Each side must compromise and new, simple rules for making such compromises might help. The President’s proposed three-year freeze of a small share of the government’s spending is barely serious. The President’s freeze gesture

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leaves out the largest parts of the budget where exactly such prioritization is required to have any real effect. The Economist called it "comically insufficient."

The President should broaden his freeze to cover the TOTAL aggregate budget (including defense and “entitlements”) and allow Congress to fight out the distribution of that total among individual line items. The share of the budget’s total assigned to entitlements (Social Security, Medicare, Welfare, etc.) would reflect Congressional Budget Office forecasts based on the rules in effect or that will be in effect over the budget period. Since the fiscally conservative years of President Clinton, the Federal government has grown beyond its optimal size. Thus the total nominal spending freeze should remain in effect until the economy’s growth reduces this level of spending to the 18 percent of GDP share we enjoyed when Clinton left office, which would take several decades. This would match the average tax revenue over most of the past 60 years. Whether the public is satisfied with what it’s government is doing is likely to have more to do with the care with which it selects its programs and determines their scope and scale, than with the level of spending. Thus within this spending cap Congress and the Administration have their jobs cut out for them and will be judged by how well they perform them.11

Taxes should be simplified and flattened and set at a level that will raise the full amount of government spending once it has fallen to 18 percent of GDP. The budget should be balanced over the business cycle. The progressivity and complexity of the current personal and corporate income taxes are unfair and inefficient discouraging investment and economic growth. I prefer a pure consumption tax (The Fair Tax—in the form of a VAT).12

Current policies will increase our debt to unsustainable levels. The global imbalances resulting from encouraging China and other surplus countries to help us finance our huge deficits are also unsustainable. These policies, especially unsustainable entitlements, must be changed, but Congress has been at an impasse over whether to cut spending or raise taxes. We should begin by finding agreement on what we as a society want the government to do—the size and nature of government. And we must commit to paying for what government does with taxes. Assigning the right things to the government (those things that only it can do best) and doing them efficiently will increase the productivity and efficiency of the entire economy, thus easing the burden of financing the government. Instituting more economically neutral and fair taxes at the same time would increase growth rates even further while restoring the public’s sense of fairness in the system.

Conclusion

Monetary policy: The Federal Reserve has the tools and the determination to keep core inflation within the 2 to 3 percent range for the foreseeable future, if the government can get its deficits under control.

The financial sector, and in particular the mortgage market, has contributed to America’s growth and high standard of living for the average American. Excessive risk taking and leverage needs to be reigned in without overly stifling the market’s ability to innovate in the search for efficiency and risk spreading and mitigation. Financial assets and transactions will be a bit more expensive but safer.

• Higher capital and liquidity standards are needed against all of the risks financial firms face.
• Bankruptcy and resolution tools for critically undercapitalized firms should strike a pragmatic balance between wiping out shareholders and major creditors while protecting the rest.
• Mortgage originators should keep some stake in the game (e.g., hold at least 5% of the MBS collateralized with their mortgages).
• Underwriting standards must be strengthened, including higher minimum down payments.
• Derivatives need to be simplified, standardized and made more transparent. Most should be listed and traded on exchanges.
• Corporate governance should be strengthened to give owners more control over their appointment of directors.

Public sector debt is the most serious problem facing the country. We should focus political attention on to appropriate size and scope of government and then commit to fully financing it with tax revenue. Spending must be cut, especially on increasingly expensive “entitlements” (Social Security, Medicare, Medicaid, and Obamacare) and tax revenue, simplicity, and fairness increased (ideally a flat consumption tax—i.e., VAT) The size of government should be capped and expenditures within that limit more carefully prioritized and fully financed by taxes over the business cycle. This will not be easy but it is essential.

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